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MONETARY POLICY AND THE STATE OF THE ECONOMY

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

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MONETARY POLICY AND THE STATE OF THE ECONOMY

Wednesday, February 15, 2017

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 10:02 a.m., in room 2128, Rayburn House Office Building, Hon. Jeb Hensarling [chairman of the committee] presiding.

Members present: Representatives Hensarling, McHenry, King, Royce, Lucas, Pearce, Posey, Luetkemeyer, Huizenga, Duffy, Hultgren, Ross, Pittenger, Wagner, Barr, Rothfus, Messer, Tipton, Williams, Poliquin, Love, Hill, Emmer, Zeldin, Trott, Loudermilk, Mooney, MacArthur, Davidson, Budd, Kustoff, Tenney, Hollingsworth; Waters, Maloney, Sherman, Meeks, Capuano, Clay, Lynch, Scott, Green, Cleaver, Perlmutter, Himes, Foster, Kildee, Delaney, Sinema, Beatty, Heck, Vargas, Gottheimer, Gonzalez, Crist, and Kihuen.

Chairman HENSARLING. The Committee on Financial Services will come to order. Without objection, the Chair is authorized to declare a recess of the committee at any time.

Today's hearing is for the purpose of receiving the semiannual testimony of the Chair of the Board of Governors of the Federal Reserve System on the conduct of monetary policy and the state of the economy.

I now recognize myself for 3 minutes to give an opening statement.

After 8 years of the largest monetary policy stimulus in our history, and the most unconventional monetary policy in our history, Americans recently received disappointing economic news yet again. It is official: The economy grew at a measly 1.6 percent in 2016 when our historic norm is twice that. That makes 8 years of sub-par growth, 8 years of stagnant paychecks, and 8 years of unreplenished savings.

Notwithstanding good intentions at the Fed, and notwithstanding good personnel, after 8 years there is zero evidence that zero interest rates and a bloated Fed balance sheet leads to a healthy economy.

What also hasn't changed in 8 years is that the Fed continues to unlawfully pay above-market interest rates to some of the Nation's largest banks in order to prop up select credit markets. This very well could be fueling asset bubbles and is certainly harming the ability of market participants to accurately price risks. This

foray into fiscal policy clearly threatens the Fed's monetary policy independence, which should be preserved.

What also hasn't changed in 8 years is that on the regulatory side the Fed figuratively, if not literally, is taking up seats in bank boardrooms. This means that unelected Washington bureaucrats can literally direct who gets credit in our society, as opposed to competitive markets.

I will continue to say it: We must be vigilant to ensure that our central bankers do not one day become our central planners.

Fortunately, there is something big that has changed in the last 8 years, and that is an intervening election, and with it the prospect of three new members of the Board of Governors. The National Federation of Independent Business reports that optimism on Main Street soared in the wake of the election, with the Small Business Optimism Index jumping up to a 12-year high. Likewise, the number of Americans who say the Nation is now on the right track has risen by 15 percent since the election.

Clearly, Americans have a newfound expectation that our economy will grow healthier with different policies coming out of Washington. I believe the last 8 years have shown that no amount of monetary policy stimulus can make up for the fiscal policy headwinds of a cumbersome failed regulatory state, an uncompetitive tax code, Obamacare, and the Dodd-Frank Act. All of these must be remedied and changed if we are to have a healthy economy for all and bank bailouts for none.

Building that healthier economy for all clearly requires changes at the Fed. We must have a more predictable, disciplined, and transparent monetary policy.

The Fed's so-called data-dependent monetary policy of today says nothing about which data matter, let alone how they matter. This severely compromises the kind of policy transparency and predictability that is necessary for household wealth to grow and American companies to create jobs.

Something else that has changed in the last 8 years is the introduction of the reforms included in the Financial Choice Act, which would begin to restore the Fed's independence and promote economic growth.

Several Nobel Prize-winning economists, former Treasury Secretaries, and former senior economic policy officers have said, when they endorsed the Financial Choice Act, that these reforms would ensure a monetary policy framework that is truly data-dependent, consistent, and predictable. The Financial Choice Act will help consumers and investors make better decisions in the present, and form better expectations about the future, and I look forward to its passage.

I now recognize the ranking member for 4 minutes for an opening statement.

Ms. WATERS. Thank you, Mr. Chairman.

And thank you, Chair Yellen, for testifying here today. Each day as a new episode of chaos unfolds at the Trump White House, working families across the country are reminded that our hard-fought gains to create more than 16 million private sector jobs, lift wages, stabilize the housing market, rein in Wall Street's abusive

practices, and make affordable health care accessible are in jeopardy.

Mr. Trump has already shown America what he is really all about. He has taken steps to roll back the Dodd-Frank Wall Street reform law based on the false premise that businesses do not have the ability to get loans, ignoring the National Federation of Independent Businesses survey showing that 96 percent of small businesses said their borrowing needs are satisfied.

In addition to rolling back financial protections, Mr. Trump has moved to eliminate safeguards that protect Americans planning for retirement from being ripped off by financial advisers, repealed a plan to cut mortgage insurance premiums that would have saved homeowners $500 a year, called for tax cuts for the rich at the expense of the poor and middle class, vowed to eliminate health insurance for 28 million people, aligned himself with Republican leaders in Congress in cutting Social Security and Medicare, threatened a trade war with two of our largest trading partners, and adopted an anti-immigrant agenda.

Taken all together, these policies will shrink our economy, worsen inequality, lift inflation, reduce exports, eliminate jobs, explode Federal budget deficits, and ultimately steer us in the direction of another Great Depression. Simply put, the Trump agenda is bad for America.

Chair Yellen, on top of all of this and despite your important contributions to our economic recovery, my Republican colleagues continue to attack your policies, deflecting from their own failure to provide a fiscal stimulus that would have complemented rather than undermined the Fed's bold efforts in recent years.

Now Republicans are doubling down on their efforts to inject partisan politics into Fed decision-making. Indeed, Republicans on this committee have sought to weaken the independence of the Fed and have called for chaining policy decisions to a mathematical formula that would hamper the Fed's ability to support the economy amid a severe and persistent shock.

Their agenda makes you wonder: Do Republicans not remember the 11 million Americans who lost their homes, the $13 trillion taken from the savings of hardworking Americans, the nearly 9 million Americans who lost their jobs, and when the unemployment rate hit 10 percent? While our economy has made significant gains, hardworking American families simply can't afford another Great Recession.

Despite the progress we have made, many communities across America continue to struggle, particularly minority communities, which were disproportionately hit by the crisis. On average, African-American households lost 52 percent of their wealth, Hispanic households lost 66 percent, and White households lost 16 percent.

In these tumultuous times and with more progress that must be made for vulnerable communities, your steady leadership and an independent Fed that advocates for the interests of all Americans is now more important than ever.

Mr. Chairman, I yield back the balance of my time.

Chairman HENSARLING. The gentlelady yields back.

The Chair now recognizes the gentleman from Kentucky, Mr. Barr, the chairman of our Monetary Policy and Trade Subcommittee, for 2 minutes.

Mr. BARR. Thank you, Mr. Chairman.

In November, the American people delivered a loud and clear message that they want major changes in Washington. With Governor Tarullo's resignation, President Trump will have an opportunity to make major changes at the Fed, filling three vacancies on the Board of Governors, including the Vice Chair for Supervision.

Many financial institutions in my district and around the country are concerned that the Fed may cram through a new wave of regulations before these new Governors are confirmed. Given the avalanche of red tape produced by Dodd-Frank, and the disproportionate costs imposed on small community banks, it is imperative that the Federal Reserve refrain from issuing any new regulations until the new Governors are confirmed.

New Fed Governors mean a new opportunity to examine the Fed's unconventional monetary policies. Since the beginning of the recovery in 2009, the Fed's improvisational policies, including near-zero interest rates, 3 rounds of quantitative easing, and a $4.5 trillion balance sheet, have failed to deliver their predicted result. GDP growth during the Obama Administration averaged a mere 1.8 percent, well below the growth forecast by the Fed and not even close to the 3.5 percent to 4 percent growth average during previous recoveries.

The American people are ready for a change—a change from the Fed's unconventional and unpredictable policies, a change from the Fed's inaccurate projections of growth, and a change from disappointing economic results. It is time for the Fed to begin prudently shrinking its balance sheet; end its easy-money policies that have fueled government borrowing; and shift to a more firmly grounded, strategy-based policy that will assure price stability, facilitate commerce wherever it shows promise, and create the conditions for strong economic growth.

To paraphrase Milton Friedman, it is time we stop assigning to monetary policy a larger role than it can perform, asking it to accomplish tasks that it cannot achieve, and as a result preventing it from making the contribution that it is capable of making.

I look forward to your testimony, Chair Yellen, and I thank you for your time.

Chairman HENSARLING. The Chair now recognizes the gentleman from Michigan, Mr. Kildee, for 1 minute.

Mr. KILDEE. Thank you, Mr. Chairman, and Madam Ranking Member.

And welcome, Chair Yellen.

The new Administration enters with a tailwind of economic growth at its back. With 83 months of continuous private sector job growth and an unemployment level of 4.8 percent, we do have a strong economic foundation to continue to build upon.

So it is important that the growth of the last 8 years is not put at risk through wholesale repeal of the legislative framework that has protected consumers, strengthened the financial system, and helped our economy find its footing after the greatest financial crisis since the Great Depression.

So I look forward to hearing from you about how the Federal Reserve will continue to set monetary policies that will expand our economic progress and allow for growth in areas such as workers' wages that have been more slow to recover, and in particular to address the uneven nature of growth. The United States still has pockets of poverty in urban and rural communities.

I look forward to hearing your comments, and I appreciate your attendance here at the committee. Welcome back.

With that, I yield back.

Chairman HENSARLING. The gentleman yields back.

Today, we welcome the testimony of the Honorable Janet Yellen, Chair of the Federal Reserve Board of Governors. Chair Yellen has previously testified before this committee on numerous occasions, so I certainly believe she needs no further introduction.

Welcome, Madam Chair. Without objection, your written statement will be made a part of the record, and you are now recognized to give an oral presentation of your testimony.

STATEMENT OF THE HONORABLE JANET L. YELLEN, CHAIR, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mrs. YELLEN. Thank you.

Chairman Hensarling, Ranking Member Waters, and other members of the committee, I am pleased to present the Federal Reserve's semiannual monetary policy report to the Congress. In my remarks today I will briefly discuss the current economic situation and outlook before turning to monetary policy.

Since my appearance before the committee last June, the economy has continued to make progress toward our dual-mandate objectives of maximum employment and price stability. In the labor market, job gains averaged 190,000 per month over the second half of 2016, and the number of jobs rose an additional 227,000 in January. Those gains bring the total increase in employment since its trough in early 2010 to nearly 16 million.

In addition, the unemployment rate, which stood at 4.8 percent in January, is more than 5 percentage points lower than where it stood at its peak in 2010 and is now in line with the median of the Federal Open Market Committee (FOMC) participants' estimates of its longer-run normal level. A broader measure of labor under-utilization, which includes those marginally attached to the labor force and people who are working part time but would like a full-time job, has also continued to improve over the past year.

In addition, the pace of wage growth has picked up relative to its pace of a few years ago, a further indication that the job market is tightening. Importantly, improvements in the labor market in recent years have been widespread, with large declines in the unemployment rates for all major demographic groups, including African-Americans and Hispanics. Even so, it is discouraging that the jobless rates for those minorities remain significantly higher than the rate for the Nation overall.

Ongoing gains in the labor market have been accompanied by a further moderate expansion in economic activity. U.S. real gross domestic product is estimated to have risen 1.9 percent last year, the same as in 2015. Consumer spending has continued to rise at a healthy pace, supported by steady income gains, increases in the

value of households' financial assets and homes, favorable levels of consumer sentiment, and low interest rates. Last year's sales of automobiles and light trucks were the highest annual total on record.

In contrast, business investment was relatively soft for much of last year, though it posted some larger gains towards the end of the year, in part reflecting an apparent end to the sharp declines in spending on drilling and mining structures. Moreover, business sentiment has notably improved in the past few months.

In addition, weak foreign growth and the appreciation of the dollar over the past 2 years have restrained manufacturing output. Meanwhile, housing construction has continued to trend up at only a modest pace in recent quarters. And while the lean stock of homes for sale and ongoing labor market gains should provide some support to housing construction going forward, the recent increases in mortgage rates may impart some restraint.

Inflation moved up over the past year, mainly because of the diminishing effects of the earlier declines in energy prices and import prices. Total consumer prices, as measured by the personal consumption expenditures, or PCE, index, rose 1.6 percent in the 12 months ending in December, still below the FOMC's 2 percent objective, but up 1 percentage point from its pace in 2015. Core PCE inflation, which excludes the volatile energy and food prices, moved up to about 1.75 percent.

My colleagues on the FOMC and I expect the economy to continue to expand at a moderate pace, with the job market strengthening somewhat further and inflation gradually rising to 2 percent. This judgment reflects our view that U.S. monetary policy remains accommodative, and that the pace of global economic activity should pick up over time, supported by accommodative monetary policies abroad.

Of course, our inflation outlook also depends importantly on our assessment that longer-term inflation expectations will remain reasonably well-anchored. It is reassuring that while market-based measures of inflation compensation remain low, they have risen from the very low levels they reached during the latter part of 2015 and the first half of 2016.

Meanwhile, most survey measures of longer-term inflation expectations have changed little on balance in recent months. As always, considerable uncertainty attends the economic outlook. Among the sources of uncertainty are possible changes in U.S. fiscal and other policies, the future path of productivity growth, and developments abroad.

Turning to monetary policy, the FOMC is committed to promoting maximum employment and price stability, as mandated by Congress. Against the backdrop of headwinds weighing on the economy over the past year, including financial market stresses that emanated from developments abroad, the committee maintained an unchanged target range for the Federal funds rate for most of the year in order to support improvement in the labor market and an increase in inflation toward 2 percent.

At its December meeting the committee raised the target range for the Federal funds rate by one-quarter percentage point to 0.5 to 0.75 percent. In doing so, the committee recognized the consider-

able progress the economy made toward the FOMC's dual objectives. The committee judged that even after this increase in the Federal funds rate target, monetary policy remains accommodative, thereby supporting some further strengthening in labor market conditions and a return to 2 percent inflation.

At its meeting that concluded early this month, the committee left the target range for the Federal funds rate unchanged but reiterated that it expects the evolution of the economy to warrant further gradual increases in the Federal funds rate to achieve and maintain its employment and inflation objectives. As I noted on previous occasions, waiting too long to remove accommodation would be unwise, potentially requiring the FOMC to eventually raise rates rapidly, which could risk disrupting financial markets and pushing the economy into recession. Incoming data suggest that labor market conditions continue to strengthen and inflation is moving up to 2 percent, consistent with the committee's expectations.

At our upcoming meetings, the committee will evaluate whether employment and inflation are continuing to evolve in line with these expectations, in which case a further adjustment of the Federal funds rate would likely be appropriate.

The committee's view that gradual increases in the Federal funds rate will likely be appropriate reflects the expectation that the neutral Federal funds rate—that is, the interest rate that is neither expansionary nor contractionary and that keeps the economy operating on an even keel—will rise somewhat over time.

Current estimates of the neutral rate are well below pre-crisis levels, a phenomenon that may reflect slow productivity growth, subdued economic growth abroad, strong demand for safe longer-term assets, and other factors. The committee anticipates that the depressing effect of these factors will diminish somewhat over time, raising the neutral funds rate, albeit to levels that are still low by historical standards.

That said, the economic outlook is uncertain and monetary policy is not on a preset course. FOMC participants will adjust their assessments of the appropriate path for the Federal funds rate in response to changes to the economic outlook and associated risks, as informed by incoming data. Also, changes in fiscal policy or other economic policies could potentially affect the economic outlook.

Of course, it is too early to know what policy changes will be put in place or how their economic effects will unfold. While it is not my intention to opine on specific tax or spending proposals, I would point to the importance of improving the pace of longer-run economic growth and raising American living standards with policies aimed at improving productivity.

I would also hope that fiscal policy changes will be consistent with putting U.S. fiscal accounts on a sustainable trajectory.

In any event, it is important to remember that fiscal policy is only one of the many factors that can influence the economic outlook and the appropriate course of monetary policy. Overall, the FOMC's monetary policy decisions will be directed to the attainment of its congressionally mandated objectives of maximum employment and price stability.

Finally, the committee has continued its policy of reinvesting proceeds from maturing Treasury securities and principal payments from agency debt and mortgage-backed securities. This policy, by keeping the committee's holdings of longer-term securities at sizable levels, has helped maintain accommodative financial conditions.

Thank you. I would be pleased to take your questions.

[The prepared statement of Chair Yellen can be found on page 68 of the appendix.]

Chairman HENSARLING. Thank you, Madam Chair.

The Chair now yields himself 5 minutes for questions.

Madam Chair, as I know you are aware, on February 3rd President Trump issued an Executive Order of core principles to regulate the United States' financial system. Section one, paragraph C says, "Foster economic growth and vibrant financial markets through more rigorous regulatory impact analysis."

You were quoted yesterday in your Senate testimony saying that you agree with these core principles. Were you quoted accurately?

Mrs. YELLEN. Yes. I agree with the core principles that the President enunciated.

Chairman HENSARLING. As you probably know, to date, Dodd-Frank has promulgated at least 22,000 pages of regulations as part of its 400 rules, I think only roughly three-quarters of which have been finalized, and certainly the weight and the volume, the complexity and the cost is one of the headwinds that we are facing now.

I know that as an independent agency, you are not necessarily subject to the jurisdiction of the Executive Order, but we have had testimony in this committee for years about the challenges of the Volcker Rule and its deleterious impact on market illiquidity.

On December 22nd of last year, just weeks ago, the Federal Reserve released a staff paper, an abstract of which says, "We document that the illiquidity of stress bonds has increased after the Volcker Rule. Since Volcker-affected dealers have been the main liquidity providers, the net effect is that bonds are less liquid during times of stress due to the Volcker Rule." It goes on to say that the Volcker Rule may have serious consequences for corporate bond market functioning in stress times.

Do you agree with the staff paper of the Federal Reserve?

Mrs. YELLEN. This was the work of a particular staff member and not a finding of the Board as a whole.

Chairman HENSARLING. I understand. I am just trying to figure out, do you agree or disagree with these conclusions?

Mrs. YELLEN. I think the evidence on this matter is conflicting, and I think this paper did find evidence of an impact in one particular area. This is an important question. It is one we continue to look at. And there are a number of factors—

Chairman HENSARLING. You have been looking at it for years, though, haven't you, Madam Chair? Haven't you been looking it for years now?

Mrs. YELLEN. Yes, we have been—

Chairman HENSARLING. Still no conclusion?

Mrs. YELLEN. It is difficult to come to a conclusion because by most metrics, liquidity in corporate bond markets still remains healthy, but there is—

Chairman HENSARLING. So after a couple of years, not drawing a conclusion yet, I assume that there is no particular action the Board intends to take based upon the evidence of this paper, is that correct?

Mrs. YELLEN. There is no action that we intend to take based on that—

Chairman HENSARLING. Okay.

Madam Chair, in the January 25th edition of The Wall Street Journal, Ms. Nellie Liang, whom I assume you are acquainted with, stepped down as the Director of your Financial Stability Division. In this article, she said that, "Congress should provide clarity for regulators on how to balance the safety of the financial system with economic growth."

Please know that Congress does not believe that you have found the proper balance and that the Volcker Rule is an incredibly important channel to fund jobs in America. Again, I don't know how much stronger the evidence has to be for the Fed to take action, but please know the proper balance has not been struck.

On January 12, 2017, the Financial Stability Board released its policy recommendations to address structural vulnerabilities from asset management activities. Governor Tarullo was quoted as saying the policies "will better prepare asset managers in funds for future stress events." Many cannot see any association whatsoever with the terms "systemic risk" and "asset management."

So my first question is, are you aware of anybody in the Administration directing either you or Governor Tarullo to negotiate with the Financial Stability Board on asset management regulation?

Mrs. YELLEN. It is done in negotiation with the Financial Stability Board. Any regulation that is put into effect in the United States has to go through a rulemaking process.

Chairman HENSARLING. I understand that, but the question was, has there been any contact with the new Administration authorizing the Fed to carry on any negotiations with respect to the asset management question with the Financial Stability Board?

Mrs. YELLEN. We participate regularly as part of our established responsibilities in discussions with colleagues in the—

Chairman HENSARLING. As you know, Governor Tarullo was never confirmed by the Senate. Are you aware of any specific statutory authority he has to negotiate on behalf of the United States on the matter of asset management and systemic risk?

Mrs. YELLEN. I don't think it is a negotiation. The SEC is involved; Treasury takes part in those discussions. There are a number of U.S.—

Chairman HENSARLING. Do you believe that the new Administration should have the ability to nominate a Vice Chair for Supervision, and if confirmed, that person would be the one to be officially tasked with these duties?

Mrs. YELLEN. We look forward to a nomination to the position of Vice Chair for Supervision and—

Chairman HENSARLING. Don't we all, Madam Chair. Don't we all.

My time has expired. I now recognize the ranking member for 5 minutes.

Ms. WATERS. Thank you very much.

Madam Chair, we have frequently heard from members on the opposite side of the aisle that Dodd-Frank has had a significant adverse impact on our economy. To fact-check some of this gloomy rhetoric I ask that you provide some brief responses to the following questions:

Since passage of the Wall Street reform law, has business lending by commercial banks expanded or contracted?

Mrs. YELLEN. Expanded.

Ms. WATERS. Roughly how many private sector jobs have been added to our economy?

Mrs. YELLEN. Roughly 16 million since the trough in employment in early 2010.

Ms. WATERS. Have wages increased or decreased in the past year?

Mrs. YELLEN. They have increased, by most measures.

Ms. WATERS. Has the trend in aggregate household net worth been positive or negative?

Mrs. YELLEN. Positive.

Ms. WATERS. Has the trend in Federal budget deficit risen or fallen over the past few years?

Mrs. YELLEN. Deficits have declined since the financial crisis and its aftermath.

Ms. WATERS. After the economy hit bottom, have the number of foreclosures increased or decreased in recent years?

Mrs. YELLEN. They are, I believe, decreasing now.

Ms. WATERS. What, in your view, are the key factors and policies that have contributed to these positive trends in the economy?

Mrs. YELLEN. The economy is recovering from a very severe crisis. We have put in place stronger financial regulation that has armed four-star banks to build up their capital buffers to deal with problem loans and to strengthen themselves to the point where they have been able to support economic growth and recovery in our economy. The U.S. economy has recovered more quickly, for example, than the E.U. economies have in the aftermath of the crisis.

And the Federal Reserve has put in place highly accommodative monetary policies meant to spur spending in the economy and restore low unemployment or to achieve the goal of maximum employment and price stability that have been assigned to us by Congress. As I indicated in my remarks, I believe we are coming very close to achieving those objectives and that monetary policy still remains accommodative.

Ms. WATERS. Thank you.

Chair Yellen, as the Nation's leading economist, can you discuss how unraveling the fabric of our social safety net, such as through cuts to food assistance programs for families in poverty, eliminating access to affordable health care, eliminating the earned income tax credit and the child tax credit, cutting unemployment insurance benefits, and cutting funding for housing assistance programs could impact the short-term and long-term health of our workforce and our economy? Could these types of cuts do permanent damage to our economy's ability to fulfill its potential? How

would cuts to these programs impact inequality and the chance that families have to escape poverty?

Mrs. YELLEN. I don't want to give detailed guidance to Congress on these particular programs. But I would say that the trend of rising inequality and the fact that, although low-income households have done well over the last couple of years as the economy has improved relative to before the crisis and even looking back a number of decades, they have clearly faced very severe problems that have left many American households struggling, and these kinds of programs are helpful, I think, in dealing with such distress.

Ms. WATERS. Could you just give me a few more minutes on the earned income tax credit? Do you think that is important?

Mrs. YELLEN. I think it does serve to support the incomes of many lower-income families.

Ms. WATERS. And what about the child tax credit in particular?

Mrs. YELLEN. That works in the same direction.

Ms. WATERS. So, as you said, you don't wish to tell Congress what to do, but these programs are important. And would you include in that cutting the unemployment insurance benefits as being beneficial to helping lift families out of poverty?

Mrs. YELLEN. I think unemployment insurance benefits are important for families who face real distress in the labor market, and they also serve as automatic stabilizers that support spending in a the downturn and make our economy less subject to the fluctuations of the business cycle.

Ms. WATERS. Thank you very much.

I yield back.

Chairman HENSARLING. The time of the gentlelady has expired.

The Chair now recognizes the gentleman from Kentucky, Mr. Barr, chairman of our Monetary Policy and Trade Subcommittee.

Mr. BARR. Thank you, Mr. Chairman.

And, Chair Yellen, welcome back to the committee. This is the first time I have had an opportunity to visit with you as the new chairman of the Monetary Policy and Trade Subcommittee, and I look forward to visiting with you on a more informal basis to get your thoughts about monetary policy and your supervisory responsibilities.

My intention is to be fair-minded in our oversight and also encourage an exchange of differing viewpoints, but we are also going to ask tough questions because the American people do deserve a Federal Reserve System that is transparent, accountable, and predictable.

According to your monetary policy report from a couple of years ago, Chair Yellen, the Federal Open Market Committee expected that, "with appropriate policy accommodation, economic activity would expand." The FOMC certainly pursued that accommodative policy, holding the Fed funds rate to near zero for almost a decade and growing the Fed's balance sheet to one quarter of the size of our economy.

You noted in your prepared testimony that labor market conditions are strengthening and that we are moving toward that inflation target of 2 percent. But despite all of the extraordinary measures and the unconventional policies, economic activity has still fallen short of FOMC expectations and has done so throughout the

recovery. What does the serial failure of the Fed's forecasts tell us about the efficacy of Q.E. and the ballooning balance sheet?

Mrs. YELLEN. The Congress' instructions to the Federal Reserve are to try to achieve maximum employment and price stability. We have focused on those objectives—not economic growth per se, but maximum employment.

The economic growth performance has been quite disappointing and growth is falling short of our expectations, but unemployment has come down substantially and we are quite close, I would say, to achieving our labor market objectives.

Now, the reason for this is that productivity growth in the U.S. economy, which is what really determines in the long run the pace of growth—

Mr. BARR. Right.

Mrs. YELLEN. —our economy is capable of, has been very disappointing.

Mr. BARR. Right. I understand that and I also recognize that we have seen a repetitive failure for—of the Fed to actually achieve the expected growth rates.

And really my question that I am getting at is, doesn't this underscore the failure of unconventional policies to deliver the expected results? And if you are a reasonable person looking at this, wouldn't a reasonable person say, "Maybe we shouldn't be expecting so much from unconventional policies, near zero interest rates, 3 rounds of Q.E., a $4.5 trillion balance sheet?"

Mrs. YELLEN. My reading would be that putting in place those policies has enabled us to add 16 million jobs to the U.S. economy and—

Mr. BARR. And yet, Chair—

Mrs. YELLEN. —bring the unemployment rate down to 4.8 percent—

Mr. BARR. Sure, and I acknowledge that, and the ranking member made a big point of the declining unemployment rate. But we also have to recognize that almost 15 million people remain unemployed or underemployed 8 years after the recession. The labor participation rate is the lowest it has been since 1978.

Mrs. YELLEN. The labor—

Mr. BARR. President Obama is the only President in U.S. history since Herbert Hoover to not preside over a single year of 3 percent growth. And median household income remains nearly $1,000 lower than the pre-recession levels. So we have a bit of a different viewpoint on that.

And I recognize that you believe that the unconventional strategy has worked. But if it has worked so well, why are we still reinvesting and why are we not shrinking the balance sheet?

Mrs. YELLEN. We are beginning to remove monetary policy accommodation and we expect to continue to do so, and we have decided that the best way to do that is by raising overnight interest rates—short-term interest rates—by raising our Federal funds rate target. We are committed to shrinking our balance sheet but consider it best, from the standpoint of sustaining the recovery, to do that in a gradual and orderly way.

Mr. BARR. And I respect that, given the taper tantrum, and I recognize that viewpoint. But yesterday in the Senate Banking Com-

mittee you said you wouldn't start to shrink the Fed's balance sheet until the Fed funds rate was high enough that it could be reduced again in the event of economic turbulence. What is high enough?

Mrs. YELLEN. It depends. There is no unique level that is high enough. It depends on the strength of the recovery and how robust it is, how worried we are about downside risk to the economy. The Federal Open Market Committee in our coming meetings will be discussing reinvestment policy in greater detail, and I hope to be able to provide—

Mr. BARR. Thank you, Chair Yellen. I look forward to continuing to discuss that discretionary policy and the uncertainty it is creating.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from California, Mr. Sherman.

Mr. SHERMAN. Mr. Chairman, we have had the—obviously I did not intend my picture to be up there on the board. My staff has—I will ask them to take this down. This is a beta version and we will go back to the—okay.

I have always envied the Majority with their national debt clock. The gentleman from Kentucky tells us that he wants to blame the Fed for low interest rates, and that is why we have a national debt.

We all know that the amount of the deficit is set by the spending. That is in Congress. It is set by the taxes. That is set by Congress. And in a pitiful attempt to deflect responsibility for the fact that we have a large national debt, we are told that the blame goes to the Fed because you haven't charged us enough for the cost of borrowing.

The national debt would be even higher if our interest rates were higher and if our cost of financing the national debt were higher.

We are also told to blame President Obama for the fact that the catastrophe he inherited has not been rebounded enough. That is like blaming the firefighter for the fact that there was a fire. He found this country in freefall, we are now on the upswing, and those who were here at the time that the policies were set that created the freefall are saying, "Well, why isn't the upswing bigger?"

Finally, thank you for your large balance sheet. That creates a huge profit. That money goes to the general fund. So your low interest rates and your huge balance sheet are keeping that national debt clock that the Majority puts up from turning much, much faster.

Now, I do want—at the next meeting we will have the technology done properly. We will have the national trade deficit clock.

It stands at over $11 trillion of accumulated trade debt since 1980, and that is including both goods and services. It would be higher if we just looked at goods. That clock is often turning faster and that clock is as a result of the terrible trade policies that have been embraced by both sides of Pennsylvania Avenue from time to time.

Eric Holder pointed out that he hesitated to engage in criminal prosecutions of the biggest banks because they were so large that he feared for the effect on the national economy. You have been here before and I have urged you to break up the too-big-to-fail in-

stitutions. You have said you are going to achieve those goals through another means.

So can you assure the current attorney general that we can enforce the criminal law fairly, we can let the chips fall where they may, and the economy will be just fine no matter how big the institution that faces criminal prosecution and no matter how big the figures are who are put in jail? Can you tell us that as of today, no one is too-big-to-jail?

Mrs. YELLEN. Certainly, I agree that the Justice Department should pursue any criminal indictments—

Mr. SHERMAN. Would the downfall of any one or two institutions have an adverse effect on our economy that should give a reasonable attorney general some pause before taking action?

Mrs. YELLEN. Through the process that we have put in place, the living will process, the strengthening of the capital and liquidity positions of the largest firms—

Mr. SHERMAN. Yes or no? Can we feel free to engage in criminal prosecutions of even the largest one or two institutions without an adverse economic effect? Yes or no?

Mrs. YELLEN. I believe there is a very reasonable chance we would be able to—

Mr. SHERMAN. One last question. The battle in Dodd-Frank is basically a battle to reduce the amount of capital that the big banks have to face. The Wall Street Journal reported that if we got rid of it or moved against it, that would liberate about $100 billion that the banks could pay out in dividends or share buybacks.

Would it increase or decrease the risk that a giant institution would need a bailout if we told them that they should have less capital on hand and were free to take some of the capital they have and pay it out in dividends now?

Mrs. YELLEN. We believe very strongly in high capital levels, especially for the largest and most systemic institutions, and we think it will support their ability to supply credit to U.S. households and businesses even in a very adverse scenario. It strengthens their resilience and vastly reduce their odds of failing.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from New Mexico, Mr. Pearce, chairman of our Terrorism and Illicit Finance Subcommittee.

Mr. PEARCE. Welcome, Chair Yellen. Thanks for being here. I always appreciate your viewpoints.

Now, as I read your report that you just gave to us, on page one you are talking about the progress towards maximum employment. And so you give—I am just trying to get the flow in my mind here correctly.

So you have made progress and then later, you say that the FOMC believes that unemployment is pretty well at its normal level, that is, it is where it needs to be. Labor under-utilization is a little bit of a concern but it is kind a marginal concern, that it is these pockets of maybe minorities or things.

Is that more or less kind of the summary? Am I reading your report correctly?

Mrs. YELLEN. We think that the economy is—

Mr. PEARCE. No. I didn't ask about the economy.

Mrs. YELLEN. The labor market—

Mr. PEARCE. I was talking the labor force and—

Mrs. YELLEN. —is—

Mr. PEARCE. —employment and the unemployment seems to be where you think it ought to be.

Mrs. YELLEN. Essentially. There are—

Mr. PEARCE. Essentially, okay.

Mrs. YELLEN. As you said and as we say in the report, there are pockets of—

Mr. PEARCE. Yes. I understand, but basically you are giving a fairly glowing, stable report. Okay.

Mrs. YELLEN. Well—

Mr. PEARCE. Now, my point—

Mrs. YELLEN. But let me be clear, I am not saying that all workers or all individuals—

Mr. PEARCE. You give those reservations there. We have pockets. We have seen large declines in employment for major demographic groups, but we have discouraging jobless highs for minorities. I give you your balancing statements there.

My point is that this stable position that you have established, that we have done pretty well, then we have some pockets that we need to improve on, is highly discouraging because 4 out of 10 people who could be in the workforce are not. And for the 60 percent who are, it tells us that the highest economic body in the country says it is okay that you 40 percent are not there, that we don't draw attention to the 62 percent labor force participation rate. It is just ignored and things are fairly stable according to your report and according to our questions.

Yesterday, a New York Times article stated that—and I am trying to get at this if it is accurate—Mrs. Yellen and other Fed officials have suggested that the central bank would seek to offset such measures—that is, Mr. Trump calling for stimulating economic growth through tax cuts—but that you would seek to offset that because the Fed judges the economy to be growing at roughly the maximum sustainable pace already.

Is that accurate news? Is that accurate, that you believe that we are pretty close to the maximum sustainable pace already?

Mrs. YELLEN. I have urged Congress and the Administration to focus on measures that would raise the potential of the economy to grow, that would increase productivity growth and the capacity—

Mr. PEARCE. So this statement in the New York Times is incorrect—

Mrs. YELLEN. It is not—

Mr. PEARCE. —that you all do not believe—you do not—

Mrs. YELLEN. It is not quite accurate and I don't believe that accurately reflects my words.

Mr. PEARCE. So this would be some of the fake news coming out from the New York Times yesterday.

Mrs. YELLEN. I think that there are policy measures that Congress and the Administration could consider—

Mr. PEARCE. Okay.

Mrs. YELLEN. —that would boost the capacity of the U.S. economy—

Mr. PEARCE. So is there a maximum rate at which you all do become concerned about economic growth?

Mrs. YELLEN. I think faster economic growth, if it is supported by either faster labor force growth or productivity growth—

Mr. PEARCE. The question is, is there a maximum? I am kind of running out of time. Is there a position at which the Fed gets uncomfortable with economic growth? Is there a number at which you get uncomfortable? If it goes to 7.4 percent you are going to be okay with that?

Mrs. YELLEN. No. I think we would like to see fast growth, but we do have to control price inflation—

Mr. PEARCE. You would do things, then, to offset—this idea that you would offset fast economic growth, then that has an element of truth to it?

Mrs. YELLEN. Only if we think that it is demand-based and threatens our inflation objective—

Mr. PEARCE. Yes. So let me wrap up here if I can—

Mrs. YELLEN. —has assigned to us.

Mr. PEARCE. Let me wrap up here, because when I look at employment figures and 16 million, it indicates that all jobs are created equal. And frankly, a retail job is not going to pay as well as a refinery job. And when the President is talking about expanding the economy and I see comments that indicate you all from the Fed might do things to sidetrack that growth rate when he is going to increase infrastructure and the $60,000 a year jobs, I worry about that.

I worry about it being considered that small business growth is not as good as or maybe it is even equivalent as the economic growth by international corporations. So again, I worry when I see these things.

I yield back the balance of my time, Mr. Chairman. Thank you.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from New York, Mr. Meeks.

Mr. MEEKS. Thank you, Mr. Chairman.

Madam Chair, it is good to see you. And I can't believe my ears as I stand here, or sit here, because I guess I am hearing revisionist history, and I wonder about my colleagues who claim that they are worried now.

But if I recall correctly—and I think I do because I got elected in 1998, I came here in 2000—at that time we were talking about balanced budgets and a moving economy. And in the 2000 election, we had a Republican Majority in the House, a Republican Majority in the Senate, and a Republican President, similar to what we have right now.

And as I recall, during that period of time all of a sudden we were not talking about balanced budgets anymore, we were talking about rising deficits. Democrats clearly had nothing to do with that because we had no control over anything, as it is right now. And we moved forward and we ended up in the greatest recession since the Great Depression.

The fact of the matter is—and these are not alternative facts—that when Barack Obama became President of the United States of America, we were losing. You talk about slow growth—I figure,

you can correct me if I am wrong—we were losing about 700,000 jobs a month, not gaining anything. Not because of Democrats. Barack Obama wasn't the President.

So he inherited a economy that was falling. I can remember the Secretary of the Treasury coming over to the House begging Democrats to do something at the time because even the Republicans wouldn't do anything, asking for our help to get something passed to save this economy.

That is not revisionist history; those are facts that took place.

And under Barack Obama we have made tremendous progress from where we were. To the fact that as opposed to losing jobs, as we were beforehand, I think you testified we have now gained over 16 million jobs. I think that should be something that all of us as Americans should be applauding and not criticizing because we have come a mighty long way from an economy that was in the tank.

And we had to do certain things because we didn't want to get back there ever again. We wanted to make sure that we didn't put the American people, the workers—whether you are Democrat, whether you are Republican, whether you are independent, whether you are Black, whether you are White, whether you are Hispanic—we didn't want people to be put in that position again. So we had to come up with some new laws.

One of them was called Dodd-Frank. And as a result of Dodd-Frank, we saw some stabilization in institutions and we began to move forward and we began to create jobs again. And here we are now creating some of the same kind of uncertainty.

So let me just ask a question because I believe—I don't know, maybe I am wrong, but I think that in the Fed's monetary policy report you did with that, uncertainty hurts you with your report as well as it affects employers and business owners. And when you have uncertainty, whether or not it is dealing with immigration, whether or not it is dealing with trade, whether or not it is dealing with regulatory policy, that causes problems in the economy. Is that not correct?

Mrs. YELLEN. It can be. That is for many years a problem that businesses have cited that has made them reluctant to make commitments. It is hard to quantify just how important that is.

Mr. MEEKS. One of the things that I do know is that over the last 14 days, we certainly have had not anything certain with this current Administration. In fact, every day that we wake up it is something new and uncertain dealing with this Administration. Every day. Every day. I don't know one day when we have not woken up and looked and read the papers or looked at the television or something and it has been something new.

Now, there have been some excuses—but the fact of the matter is we have had anything but certainty for the last 14 days in the United States of America. We have had none, and that thereby will have an effect overall on the average everyday worker in the United States of America, our businesses, our small businesses, our banks, our regulations, and even, in fact, our credibility.

Because guess what? In the current Administration they don't even trust one another. We have a situation where the Vice Presi-

dent doesn't trust this one, and the President has already said, "It is a matter of trust; I have to get rid of this one or that one."

And then you have the situation where one person comes in and says, "Oh look, the President didn't do this; the person resigned by themselves." Then the next hour someone says, "Oh, the President fired them."

Uncertainty. Our country is in an uncertain position right now, which will affect our economy and, unfortunately, the gains that we have made. So I am hoping that there is something that changes immediately so the gains that we have made over the last 8 years, we don't go back to where we were, where we were losing 780,000 jobs.

My time is up and I yield back.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from North Carolina, Mr. McHenry, vice chairman of the committee.

Mr. MCHENRY. Chair Yellen, thank you so much for being here today.

I support the Federal Reserve's function as an independent policymaker when it comes to our monetary policy. I think an independent Federal Reserve, for the purposes of monetary policies, is very important.

You are also a regulator. And as I have asked you before, that is really what I am interested in what you do in terms of regulation.

And so let me just ask, do you think it is appropriate for Congress to have oversight of the Federal Reserve's rulemaking and regulatory policies?

Mrs. YELLEN. Of course.

Mr. MCHENRY. Okay. That is good. So do you think Congress should have oversight over the Federal Reserve's regulatory discussions with international bodies, as well?

Mrs. YELLEN. Congress has assigned the various regulatory agencies responsibilities, and in carrying those out—

Mr. MCHENRY. And I am asking you as a—

Mrs. YELLEN. —we have, and I believe should have, discussions with our international colleagues.

Mr. MCHENRY. I will get to that question. I certainly understand that because Congress has given you this authority and given you this directive, should Congress not also have oversight over that authority in which we have given you?

Mrs. YELLEN. Congress of course has oversight over our conduct.

Mr. MCHENRY. So you agree that both domestically and internationally, we should have oversight over those rulemaking activities. Okay.

In accordance with that, I sent you a letter a couple of weeks ago, and thank you for the reply. I don't actually like the contents of it, but thank you for replying in a timely fashion before the hearing.

I asked for your assurance about your participation in these international agreements, for you to pause until the new Administration, who has a markedly different approach to these standards, has actually gotten their appointees in before you finalize any discussions internationally.

Mrs. YELLEN. Congressman, you know that nothing is a rule that is effective in the United States until regulatory agencies have gone through a normal rulemaking process, and nothing in these international discussions binds the U.S. regulatory agencies, including the Fed, to carry out agreements in our own rulemakings in the United States.

Mr. MCHENRY. I certainly understand that.

Mrs. YELLEN. And we have, in important cases, indicated that we don't agree with the outcomes of international discussions and have no intention of putting in place—

Mr. MCHENRY. In other cases, we can't even surmise whether or not your representative from the Fed has voted in the affirmative or in the negative on these agreements that we are then, as your agency comes back and foists upon us an international agreement that has not been apparently voted on because we can't surmise if you voted yes or no.

And so there is a great deal of opacity with that, and what we want is transparency in this. And transparency has been severely lacking.

So my question is very simple: When it comes to the Basel IV package, do you intend to wait to see if the new Administration has an opinion on these matters before you would make some agreement on the Basel IV package?

Mrs. YELLEN. These are all ongoing discussions in which U.S. regulators participate and, as I said, nothing is effective in the United States unless we go through a rulemaking process here.

Mr. MCHENRY. Okay. So—

Mrs. YELLEN. It is important—

Mr. MCHENRY. —I will summarize that—

Mrs. YELLEN. It is important for the United States.

Mr. MCHENRY. —as probably not, that you will probably not wait for the new Administration to put regulators in place even if those new regulators are in place and move to counteract exactly what you have achieved within an international agreement.

Yesterday, before the Senate Banking Committee, you seemed to endorse the core principles of President Trump's financial regulation Executive Order. What steps are you taking to comply with the Executive Order directive to advance America's interests in international forums, specifically as it relates to international standards like the net stable funding ratio and international insurance regulation?

Mrs. YELLEN. In the case of the international insurance regulation we have indicated that the capital standard that was proposed is not one that we think is suitable to be put in place in the United States, and I think that is a good example of the fact that matters that are discussed and may be agreed on by others are not effective in the United States unless we have gone through a full rulemaking process with opportunity for comment and response.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Massachusetts, Mr. Capuano.

Mr. CAPUANO. Thank you, Mr. Chairman.

And thank you, Madam Chair, for being here today.

You said earlier, and it has been referenced now a couple of times, that you agree with the core principles enunciated in the President's Executive Order. I just want to read a couple of them: to empower Americans to make informed choices; to prevent taxpayer-funded bailouts; to foster economic growth and vibrant financial markets; and to restore public accountability.

Everybody agrees with those core principles, but I don't see anything in here that specifically says that Dodd-Frank has been a failure and needs to be repealed. Did I miss it? I didn't see anything here that said any specific regulation in any level needs to be repealed or amended. Did I miss that? Is that in the core principles?

Mrs. YELLEN. The Executive Order asks the Treasury Secretary, working with FSOC—

Mr. CAPUANO. Just to do these things?

Mrs. YELLEN. —members to conduct a review.

Mr. CAPUANO. So this is all about motherhood, apple pie, and puppy dogs. We all love this stuff, and therefore the Executive Order, though wonderful and very powerful, means nothing.

Let me read a little bit more from it: It is to promote the financial stability of the United States by improving the accountability and transparency in the financial system, to end too-big-to-fail, to protect the American taxpayer by ending bailouts, and to protect consumers from abusive financial practices—financial service—oh, oh, excuse me. I was reading the wrong thing. That is actually the preamble to the Dodd-Frank bill.

Sounds very familiar, doesn't it? I could have mistaken that for the President's Executive Order because, again, who could oppose any of that?

So, that is wonderful. I am glad we all agree that the President's Executive Order is very powerful. By the way, don't you love Greg Meeks?

[laughter]

He hit that nail so hard and so well, that ball is still flying over Fenway Park, I will tell you. It was a great way to lead this in, and I have almost nothing further to say, but I will try.

Just out of curiosity, Madam Chair, do you or any of your high-ranking staff own any banks?

Mrs. YELLEN. No.

Mr. CAPUANO. Do you own any stock in any banks?

Mrs. YELLEN. No.

Mr. CAPUANO. Do any of your immediate family members own any banks or any stock in any banks?

Mrs. YELLEN. No.

Mr. CAPUANO. So therefore, you have—I don't know if it is formal or informal—you have no emoluments coming in to anybody at the Federal Reserve. Is that—

Mrs. YELLEN. We have a stringent set of ethics requirements to which we adhere.

Mr. CAPUANO. So you think it would be unethical if you, any of your high-ranking staff, or any of your family members were to financially benefit from the work that you do?

Mrs. YELLEN. It would be a conflict of interest for us and—

Mr. CAPUANO. That is good to hear because—

Mrs. YELLEN. —we have rules in place to—

Mr. CAPUANO. —apparently, not everybody—

Mrs. YELLEN. —prevent that.

Mr. CAPUANO. —agrees with that approach, and to me it has been a little troubling. I am glad to know that you and your staff and your family have high ethical values. I wish everyone tried to do that, but I guess that is another discussion for another day.

I also want to ask you, I know there have been a lot of concerns about making these banks—getting rid of all these regulations so they can get rid of all of that capital money that they are just sitting there doing nothing, which, of course, is not right, but that is okay. I will take that.

As I understand the capital requirements—and correct me if I am wrong—if I go to a bank and deposit $100 in my checking account, I know there will be some dollar fees here and there that I have to pay, but effectively, pursuant to the general regulation, the bank is then required to pretty much hold 6 of those dollars in a capital account, roughly 6 percent of what I have deposited. That doesn't mean it is just sitting there, but that is what they have to do.

So if the bank goes belly up and there is a run, or if I just want my money back, the bank says—if they have a problem, they have made bad choices, the economy has gone south, something—maybe there is a President who cut taxes too much or got involved in too many wars that he didn't want to pay for. But if anything happened and I went to that bank and there was a run, I could only get 6 of my dollars back based on those capital requirements.

Do you think that is sufficient that 6 percent of their assets are held in capital?

Mrs. YELLEN. Let's see. We have liquidity requirements, which would take some of your deposit and require them to hold it in—

Mr. CAPUANO. But my $100 isn't it. They don't have to sit on my $100 or, even 90 of those dollars, or 80 or 70 or 50 or 20.

Mrs. YELLEN. What we want to make sure of is that the loans that the bank makes are—

Mr. CAPUANO. Right, but you think—and I am not arguing; you are the professional—roughly $6 is sufficient to cover their needs in real times of crisis?

Mrs. YELLEN. We have a number of different ways to gauge how much capital they should have—

Mr. CAPUANO. But apparently some people on the other side are saying, "My God, that is too much. We can't keep that $6. The heck with those depositors."

Thank you, Madam Chair.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Missouri, Mr. Luetkemeyer, chairman of our Financial Institutions Subcommittee.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

And, Chair Yellen, thank you so much for being here today. Just kind of a refresher course. Some of my friends across the aisle have been talking about how wonderful and rosy things are. If you look at the GDP growth for the last several years, every year it is less than it was the year before. And if I recall, my high school math

teacher called that a negative trend line, which means you are going the wrong direction fast.

So along that line, yesterday, Chair Yellen, your testimony in the Banking Committee over in the Senate tried to paint a very rosy picture of lending in the United States, especially for small business, and you cited independent national—the National Federation of Independent Business study confirming that thought.

But what you have failed to mention was that 65 percent of the businesses that responded to the survey had no intention of borrowing. Why?

Why did they not want to borrow any money? That is the question. That is the concern.

Mrs. YELLEN. I think that is a legitimate concern that small businesses haven't seen rapid enough growth in their sales and in business overall that they feel the need to borrow. Of course, that is a concern.

Mr. LUETKEMEYER. As I go home every weekend and I talk to my small business folks, for the last several years it has been a regulatory onslaught for them, and part of it is banking regulation, which makes it difficult to get access to credit. And I will just give you one quick example.

A banker friend of mine sold his bank to a larger bank and the executive officer stayed in the bank, and over the last year they made 3 loans—3 loans in the entire bank where he normally made 30 per month. That is the kind of restriction of credit that is going on in the real world.

So I guess my question to you is, when is the last time you talked to a small business owner? Do you talk to small business owners at all?

Mrs. YELLEN. We do talk to small business owners.

Mr. LUETKEMEYER. When was the last time you personally talked to a small business owner?

Mrs. YELLEN. We have groups that come in regularly to meet with me and other Board Members.

Mr. LUETKEMEYER. When was the last—can you give me a date? Last week? Last month? Last year?

Mrs. YELLEN. Probably within the last several weeks.

Mr. LUETKEMEYER. Okay. Have you talked to a farmer lately?

Mrs. YELLEN. Talked to whom?

Mr. LUETKEMEYER. Have you talked to a farmer lately? He is a small business person.

Mrs. YELLEN. Not recently.

Mr. LUETKEMEYER. Okay. One of the other concerns that I have is because of this onslaught of regulations, and especially in the banking community, you are one of the regulators, there are obviously other groups of them here that are—in my mind are problematic with the onslaught of rules and regulations.

In my home State of Missouri, at the end of 2015, which is the year before last—I haven't gotten the numbers for last year yet—there were 44 banks total that totaled under $50 million. Those are the little bitty guys, but they service a community, a very important small community someplace in my State. Twenty-six of those lost money—26 of those 44 small banks lost money in 2015.

Now, those are all targets for either closure or a merger, and that is very concerning because, as I just stated, you wind up with a small bank being absorbed by a larger bank. It cuts the ability of small businesses in those communities to be able to have access to credit as well as every consumer, whether it is home loans or what.

And so that gets me then to my next concern, which is the clearinghouse came up with a study—a report on your CCAR. And in there it makes the statement that the Fed's process—CCAR process—is restricting lending and thwarting economic growth, particularly in small business and mortgage lending. What would your response be to that?

Mrs. YELLEN. I think that is a highly flawed study that was used.

Mr. LUETKEMEYER. A highly flawed study?

Mrs. YELLEN. Yes, and I would disagree with its findings. I could go into detail about what some of the flaws are with the methodology—

Mr. LUETKEMEYER. No. Give me an example, please.

Well, one flaw is that the clearinghouse estimates effective risk weights produced by stress tests by looking at the average quality of bank portfolios and not the quality of marginal or new loans. And that is a huge difference because the existing loan portfolio often has loans that were originated that are encountering problems and—

Mr. LUETKEMEYER. I don't disagree with you on risk weighting. I am not a big fan of risk weighting either, and as I go through the chart here it is amazing to me, you wound up having to have more capital when you risk weight for small business loans than you do for commercial industrial loans. Can you explain that?

Mrs. YELLEN. Our stress-testing methodology tries to take a forward-looking and institution-specific approach and capture—

Mr. LUETKEMEYER. Okay. Let me reframe the question. If you have a small business loan at $50,000 and you have a large industrial loan at $50 million, 100 times larger in size, tell me where the most risk is to the bank?

Mrs. YELLEN. I don't think that is the difference in risk weights implicit in our stress test.

Mr. LUETKEMEYER. I yield back.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Missouri, Mr. Clay, ranking member of our Financial Institutions Subcommittee.

Mr. CLAY. Thank you, Mr. Chairman.

And thank you, Chair Yellen, for your appearance today.

President Trump's proposals would have far-reaching negative consequences for the economy. These harmful policies include rolling back the Dodd-Frank Wall Street Reform and Consumer Protection Act, cutting taxes for the wealthy, curtailing immigration and deporting undocumented immigrants, adopting a protectionist trade policy, eliminating the Affordable Care Act, and cutting back the social safety net for vulnerable population.

And the President has also reversed a planned Federal Housing Administration mortgage insurance premium cut that would have saved homeowners $500 a year, which may not be much to some,

but for a lot of moderate-income Americans, that means something to them.

I consider the Trump agenda to be harmful to hardworking American families, and ultimately catastrophic for the whole economy.

Here is my question: After the recession of 2008, bringing in some kind of regulation over—and responsibility—over our financial institutions, including creation of the Consumer Financial Protection Bureau (CFPB), have we not learned anything since 2008?

And now we have this effort to roll back these regulations. What do you think the impact will be on our economy if we do this in a willy-nilly way?

Mrs. YELLEN. Looking back, I think we know that consumer abuses in lending and in securitization mortgage lending were an important contributor to the financial crisis and can be a source of financial instability in the future if we are not attentive to those areas and potential abuses.

Mr. CLAY. Do you believe that the CFPB has done a pretty good job of protecting our consumer, of getting them money back, and has been the backstop for our consumers? Let me hear your opinion about the CFPB.

Mrs. YELLEN. It is really for you to evaluate your judgment on their performance. But they have had a broad agenda and taken on attempts to regulate in many important areas.

Mr. CLAY. Thank you for that response.

And I know that unemployment is down; however, I think more work still needs to be done to reverse decades-long inequality that has left middle-class workers, low-income families, and minority communities behind.

Generational and systemic inequities continue to distort progress and opportunity for tens of millions of Americans. What can we do to address some of those concerns?

Mrs. YELLEN. I agree with that, and I think this ongoing inequality is something on which Congress should focus.

I think there are many public policies that are relevant. They are largely not in the domain of the Fed, but they would, for starters, involve focus on education, training, community development, and other things that would improve the chances for success of communities that have had historically serious labor market problems.

Mr. CLAY. And I appreciate that response, which tells me that Congress should be about helping this economy and going about the business of job creation and not looking to roll back regulations that are there to protect the American consumer.

My time is up. Thank you so much for your engagement.

Mrs. YELLEN. Thank you.

Chairman HENSARLING. The Chair now recognizes the gentleman from Michigan, Mr. Huizenga, chairman of our Capital Markets Subcommittee.

Mr. HUIZENGA. Thank you, Mr. Chairman.

And, Chair Yellen, it's good to see you. This is my first time not being able to engage you as Chair of the Monetary Policy and Trade Subcommittee, as I am now chairing the Capital Markets Subcommittee. I want to move on to a number of issues, but quick-

ly, do you plan to have lunch with Secretary Mnuchin as often as you did with Secretary Lew?

Mrs. YELLEN. Yes, absolutely. I look forward to a very strong working relationship with him—

Mr. HUIZENGA. Right. That is something that we had talked about previously. We pulled your public calendar, and over the last 3 years—34 months, actually—there were 68 official meetings that you had with Secretary Lew. You had 32 meetings with Members of Congress, including 8 with the ranking member, 2 with the chairman, and one with myself as Chair of Monetary Policy, and I think that is one of the reasons why I have certainly advocated for you to come more often, and as part of the FORM Act we had put in place a requirement to come up 4 times a year rather than 2 times a year.

I know some on the other side have thought that was burdensome and intrusive. I think it is good communication. So I appreciate you being here today.

Does the economy still need improving?

Mrs. YELLEN. That is a very broad question and it goes—

Mr. HUIZENGA. That would seem either yes or no.

Mrs. YELLEN. In many dimensions, yes.

Mr. HUIZENGA. Okay. I will take that.

Mrs. YELLEN. Many disappointing aspects of U.S. economic performance—

Mr. HUIZENGA. Okay. I will take that. We have seen a lot of rosy scenarios painted by some. And I will fully admit, there are incongruent data points here. The conflicting information that comes, brings a couple of jokes to mind:

Have you ever seen a one-handed economist? No.

There are liars, damned liars, and statisticians.

You can make a lot of numbers say a lot of different things, and I think we have heard some of those. But I am curious, what is the U6 unemployment rate right now?

Mrs. YELLEN. I believe it is 9.4 percent.

Mr. HUIZENGA. Yes. That is the information that I have, as well, and you talk about that on page one. You don't talk specifically about it. You do talk about the unemployment rate being 4.8 percent. You don't mention that it is the 9.4 percent.

You do use a, I guess, charmingly phrased description here of those marginally attached to the labor force to describe the U6. I think that is quite problematic.

And isn't it true, Chair Yellen, that we are in the slowest, shallowest, and most tepid recovery in the modern era since World War II?

Mrs. YELLEN. It took a long time for the economy to remove labor market slack and get unemployment down and close—

Mr. HUIZENGA. Okay. That sounds like a yes, and for—

Mrs. YELLEN. —growth has been slow in the process.

Mr. HUIZENGA. —an economist, that is pretty direct. Okay.

And is it not true that the Obama Administration is the first Administration since World War II in the modern era which has not returned the economy to pre-recession levels?

Mrs. YELLEN. I would say that the economy is at pre-recession levels now in terms of the unemployment rate and other measures of the labor market—

Mr. HUIZENGA. Unemployment, not U6, according to the numbers that I have seen. And is it not true that there have been 30 quarters—not months—30 quarters of recovery?

Mrs. YELLEN. Yes.

Mr. HUIZENGA. Right? Okay. I think that was talked about. But pretty tepid recovery, don't you think, that it has taken 30 quarters to recover to that level, even if it is close?

Mrs. YELLEN. We have had a very deep downturn.

Mr. HUIZENGA. I fully understand that. But isn't it true that the labor force participation rates are at record lows?

Mrs. YELLEN. The labor force participation rate is largely declining because we have an aging population—

Mr. HUIZENGA. Whoa, whoa, whoa.

Mrs. YELLEN. —and it will continue to do so.

Mr. HUIZENGA. Hold on. Hold on. Hold on. I have to throw the flag on that one because there is an MIT economist report that just came out recently, which found that younger workers are not entering the labor force but older workers are, and that is the only growth area and the only demographic which is seeing increases is older workers.

You are starting to sell a little flimflam here on, "No, no, it is because we are an aging demographic." But the only demographic that is entering the workforce, according to this study, is the older worker. So—

Mrs. YELLEN. The labor force participation rate of older workers is rising, but their prevalence—they work very much less, although they work more than previous generations did. Labor force participation—

Mr. HUIZENGA. They are hard workers. I am the product of one of those.

Mrs. YELLEN. —falls dramatically when people get into the retirement years—

Mr. HUIZENGA. Well, in my—

Mrs. YELLEN. —and their fractions in the U.S. population—

Mr. HUIZENGA. Okay.

Mrs. YELLEN. —are increasing.

Mr. HUIZENGA. In my remaining 10 seconds here, I just want to know, isn't it true that if we would have thrown off the shackles of unreasonable regulation, we would have had a faster, steeper recovery?

Mrs. YELLEN. I would not generally agree with that.

Mr. HUIZENGA. You would not generally agree with that. So more regulation would have caused faster recovery?

Mrs. YELLEN. By cleaning up our financial institutions and requiring them to build their capital buffers—

Mr. HUIZENGA. I did use the word "unreasonable."

Chairman HENSARLING. The time of the gentleman has expired.

Mr. HUIZENGA. Unreasonable regulation.

I yield back.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Massachusetts, Mr. Lynch.

Mr. LYNCH. Good morning, Madam Chair.

And thank you, Mr. Chairman, and Ranking Member Waters.

Chair Yellen, welcome back to the committee. I do want to talk about a couple of the statements coming out of the White House that are similar to statements made by the chairman in his bill, the Financial Choice Act. There have been extensive complaints that the level of regulation created in Dodd-Frank has prevented small businesses and other businesses from getting loans.

Now, I am in Massachusetts. I realize it is a—it may be an outlier. We have a very strong economy and the lending institutions there, I would say the environment is very robust.

But is there any evidence—I talk to my colleagues from around the country. Is there any evidence that folks aren't getting loans? Because that—I have not run into any evidence of that.

Mrs. YELLEN. Loans, core loans, and C&I lending has certainly increased at a solid pace in recent years. Survey evidence that I have cited from small business owners suggests that they do not see inadequate access to credit as a significant problem—

Mr. LYNCH. Can you talk about those surveys?

Mrs. YELLEN. The National Federation of Independent Business's most recent survey shows that only 4 percent of business owners regard themselves as not having all of the loans available to them that they would ideally like. I can't remember the exact wording.

Mr. LYNCH. So 96—that would imply—

Mrs. YELLEN. So 96 percent are fully satisfied with their access to credit. And only—

Mr. LYNCH. That would seem good to me. I don't know, am I missing something?

Mrs. YELLEN. No. And only 2 percent list inadequate access to credit as their most significant problem.

Now, I think for some small businesses they do access credit, for example, not by taking out traditional business loans but, say, by borrowing against a home equity line of credit.

Mr. LYNCH. Okay.

Mrs. YELLEN. And I think that the decline in residential property prices may have impaired that borrowing route for some small businesses. It wouldn't show up in these numbers, but generally access to business loans looks to me by most metrics to be quite adequate.

Mr. LYNCH. Thank you.

One of the other efforts in the Dodd-Frank repeal in the Financial Choice Act would be repeal of the orderly liquidation authority that was included in Dodd-Frank to preclude taxpayer bailouts in the future. I actually voted consistently against the bailouts for our banks because people in my district who didn't even have bank accounts were being asked to bail out the banks which had put our economy in the toilet.

What do you think about removing the orderly liquidation authority in Dodd-Frank?

Mrs. YELLEN. I would not want to see it removed, although I do think that bankruptcy should be the main vehicle for resolving a firm in distress. We have put in place protections that both make

it much less likely that a firm would fail, would ensure that if it did that there would be sufficient debt and equity to recapitalize the firm.

I know that the Choice Act proposes changes to the bankruptcy code that I think would be helpful in making bankruptcy work as a preferred option, but I think orderly liquidation is a backup procedure. We don't know what the circumstances might be in which a firm might fail.

An issue in bankruptcy is that firms commonly need liquidity; they need access to the equivalent of debtor-in-possession financing. Title II provides that kind of liquidity and puts the burden on the financial sector itself, not U.S. taxpayers, for bearing any burdens that may be incurred.

And I do continue to worry with bankruptcy. Although we are working closely with firms to make sure they have liquidity plans that would enable an orderly bankruptcy, that is always a concern.

Mr. LYNCH. Thank you.

Mr. Chairman, my time has expired. I yield back.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Wisconsin, Mr. Duffy, chairman of our Housing and Insurance Subcommittee.

Mr. DUFFY. Thank you, Mr. Chairman.

Chair Yellen, welcome. You have a wonderful poker face. You testify well, but I must say that your staff behind you does not.

It is interesting to watch your staff as the political shots are taken. You can't see them because they are behind you, but as the political shots are taken from the other side of the aisle, the little smiles and joy that they take behind you and the grimaces that come from our side, I just want to point that out. They do not have the poker face that you do.

You talked briefly about regulation. I will just make this point, not a question. You don't necessarily see regulation as a problem today with regard to economic growth. However, you did, the last time you testified, answer questions from me where you did note that they were a headwind to economic growth.

So I am seeing a little difference in your testimony. I don't know if that has anything to do with the election and Mr. Trump's Executive Order to wind back some of the over-burdensome regulation or not. Just an observation.

But a question for you: The size of a bank—is there any correlation with large banks and systemic risk, in your opinion? Or can there be a correlation between the size of a bank and systemic risk?

Mrs. YELLEN. It is not the only measure of systemic risk—

Mr. DUFFY. Right.

Mrs. YELLEN. —but it is generally true that the largest banks give rise to the greatest systemic risk.

And I would like to just clarify, I think we should be concerned, and I am concerned with regulatory burden. And if I haven't made that clear, that is an oversight on my part.

I didn't agree that regulation was the key factor resulting in slow growth, but we are concerned about regulatory burden. I am committed to doing everything that we can—

Mr. DUFFY. Thank you for the clarification, yes.

Mrs. YELLEN. —to reduce it, and I do want to clarify and make that clear.

Mr. DUFFY. Thank you for the clarification. I appreciate that.

So you will acknowledge it is a factor, the size of a bank as it relates to systemic risk. Since Dodd-Frank has passed, have the largest banks in America gotten bigger or smaller?

Mrs. YELLEN. Probably bigger.

Mr. DUFFY. It is easy. Bigger, that is right.

Have we seen an increase in the number of small community banks that dot rural parts of the country, like from where I come from, or have we seen a contraction of smaller community banks and credit unions?

Mrs. YELLEN. There is a consolidation—

Mr. DUFFY. There is a consolidation, right. So since Dodd-Frank we have seen big banks get bigger and we have seen a consolidation or an eradication of small community banks and credit unions.

Question for you in regard to the crisis: Did mortgage-backed securities have anything to do with the 2008 crisis?

Mrs. YELLEN. Of course.

Mr. DUFFY. Of course they did. And do you know what reform came from Dodd-Frank in regard to mortgage-backed securities, Fannie Mae, and Freddie Mac? Was there any reform to Fannie Mae and Freddie Mac?

Any GSE reform in Dodd-Frank to address one of the great causes of the crisis, which was mortgage-backed securities? Did Dodd-Frank address GSEs?

Mrs. YELLEN. It remains an open matter.

Mr. DUFFY. It remains an open question. Right, because one of the main drivers of the crisis, GSEs, weren't even addressed. They did nothing. On the root driver of the crisis they left it alone, which is concerning for us.

Now, hopefully in the next year-and-a-half we are going to be able to address our GSEs, but the promises were great about all the good that would come from Dodd-Frank, but we can't underestimate what has happened since it has been passed, where big banks have gotten bigger and we have seen the small community banks that serve my community—it is nearly impossible for them to survive, let alone thrive, with the regulatory burden.

I want ask you about the labor participation rate based on Mr. Huizenga's questions, the lack of President Obama hitting 3 percent growth. Not since President Hoover has that happened.

But with the conversation about border adjustment tax, do you have any opinions on the conversation that is now taking place in the House and the Senate and the White House on what that does to bring jobs back to America, what that does to the economy?

Mrs. YELLEN. I don't think it is appropriate for me to weigh in, in detail, on a specific fiscal measure—

Mr. DUFFY. So 30,000 feet. Not specifics, but 30,000 feet. Good idea? Well over 100 countries have some border adjustment, right?

Mrs. YELLEN. It is a complicated policy, the effects of which—

Mr. DUFFY. But many countries have this?

Mrs. YELLEN. Yes.

Mr. DUFFY. Yes.

Mrs. YELLEN. In connection with VAT taxes.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Georgia, Mr. Scott.

Mr. SCOTT. Thank you.

Welcome, Chair Yellen. First of all, I want to say thank you. I want to thank you for our work over the past 2 years together in dealing with and addressing this alarming high unemployment rate in the African-American community, and that is especially rampant within the African-American community of young African-American men ages 18 to 39.

I also appreciate your suggesting to us when we discussed it that inflation and unemployment is, indeed, your dual mission, but when it comes to targeted unemployment like this, you have only a blunt instrument. And what we should do is go and develop legislation. And in response to Mr. Clay earlier, you again reiterated that.

So now we have done that, and we have two very important pieces of legislation that address that by myself and my co-sponsors, Kevin Cramer of North Dakota, Republican; my good friend, Reverend Emmanuel Cleaver, Democratic co-sponsor from Missouri; Mia Love, of Utah; Mrs. Beatty, of Ohio. And certainly, we believe—along with Pete Sessions, who is at the Rules Committee.

But here is our issue right now: We need some help in getting a meeting with the President of the United States. This is why, as you know, the job component and training will be attached to his efforts to rebuild the crumbling infrastructure.

Secondly, the administration of this part of our legislation will be through his Secretary of Labor. And then on our education piece, in which we are asking for $95 million to help these struggling, hardworking African-American 1890s land grant institutions like Tuskegee University and Florida A&M, Fort Valley, Prairie View A&M in Texas, Lincoln University up in Missouri. But we have been unable to get a meeting.

We are at dead water, and I call upon you to ask President Trump if he would be kind enough just to give me and my co-sponsors an opportunity to come over to the White House and talk to him about these bills, because it has to be a partnership here. His Administration would have to administer it; we can only produce the policy. But if we can't get a chance to get in to talk to the President, how are we going to get his buy-in?

Chair Yellen, President Bush said on numerous occasions that he wanted to help the African-American community: "What the hell have you got to lose?" he said over and over.

Well, give us that chance.

I ask you to put the unemployment side of your mission hat on. Nobody, no Federal agency has unemployment as a mandate as the Fed does. So you have good credit to be able to go to President Trump and say, "Mr. President, I am not endorsing any legislation over there, but there is a very good package of bipartisan legislation that goes to the heart and the soul of the most devastating issue facing the African-American community today."

Tell him that we now have more African-American young men ages 18 to 39 in the prisons or on probation or parole with felony convictions. All hope is gone for them. But the problem is there is

a train leading more and more of these young men there. But if we can get those scholarships into these African-American colleges for these kids—the agricultural business and science and technology is reaching out.

And I thank you for your efforts in doing that.

Thank you, Mr. Chairman.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentlelady from Missouri, Mrs. Wagner, chairwoman of our Oversight and Investigations Subcommittee.

Mrs. WAGNER. Thank you, Mr. Chairman.

Chair Yellen, thank you for joining us today. I, too, noticed yesterday before the Senate Banking Committee that you agreed with the core principles that were part of President Trump's Executive Order calling for a review of the U.S. financial regulatory framework, and I thank you for that.

I hope that you will work with newly confirmed Treasury Secretary Mnuchin on identifying some of the regulations on the books that conflict with these principles. We have had a robust discussion about regulations.

This Executive Order requires you to consult with Treasury. What are you doing specifically, Chair Yellen, to identify the regulations that inhibit these core principles?

Mrs. YELLEN. We look forward to working with the Treasury Secretary on this project and we will cooperate fully once it is under way. I think he has only been in office for a day. The process is not yet established, but we look forward to participating in it.

Mrs. WAGNER. We look forward to hearing about that process as it goes forward and how you will be participating and coordinating with him.

As you know, President Trump has signed a few other additional Executive Orders relating to regulations—most notably, an Executive Order issuing a regulatory freeze and an order repealing two regulations for each new regulation proposed.

I understand that the Federal Reserve, as an independent agency, is exempt from these Executive Orders. However, Chair Yellen, do you plan on volunteering to comply in any capacity with these orders?

Mrs. YELLEN. In the past when there have been similar freezes put in place the Fed has—when it has had a rulemaking that has been well-telegraphed, under way for a long time, it has continued with the regulatory process, and I would expect that—there is nothing that we have put in place recently that was not well understood or ready, or most of what we would be looking at would be notices of proposed rulemaking where there would be plenty of opportunity for comment by those who might be appointed to our Board, Members of Congress and others.

Mrs. WAGNER. I thank you for that. I hope that you will be willing to voluntarily comply with these orders as you go forward when it comes to any additional rule-letting. As you know, and has been discussed in this hearing and to that point, the position of the Fed Vice Chair for Supervision has remained vacant since the passage of Dodd-Frank, and I hope that our President will be nominating a capable person to fill that position.

Since Governor Tarullo, who has been performing many of the regulatory coordination functions of that role in the meantime, has indicated that he is going to be resigning in April, what remaining regulatory agenda items, since we are discussing that, are being planned until he leaves?

Mrs. YELLEN. We have a relatively light schedule. We do have one possible rulemaking.

Mrs. WAGNER. And what is that, ma'am?

Mrs. YELLEN. I don't know what the timetable would be. It pertains to our stress tests and what is called the Stress Capital Buffer that came out of our 5-year review. I don't know just what the timetable is—it has been in the works a long time and I think the financial community is aware—

Mrs. WAGNER. Do you think that there is some benefit, ma'am, in waiting until we are able to nominate and confirm a Vice Chair for Supervision to weigh in before pressing on with further regulatory initiatives?

Mrs. YELLEN. If we were to come out with it, it would be a notice of proposed rulemaking, and a new Vice Chair for Supervision would certainly have a chance, along with others, to weigh in on that.

Mrs. WAGNER. Thank you, Chair Yellen.

In my limited time, I applaud the Federal Reserve for recently providing some limited relief to financial institutions from the qualitative, I will say, portions of stress tests, or CCAR.

As you know, the GAO issued a report late last year with several criticisms and recommendations regarding the stress testing process, particularly in regards to transparency. What are the Fed's plans for considering and implementing the GAOs recommendations, ma'am?

Mrs. YELLEN. We certainly value and accept those recommendations and intend to implement them in our—

Mrs. WAGNER. Thank you. Does the Fed have any plans on doing a more comprehensive review of how it conducts stress tests?

Mrs. YELLEN. We are completing a 5-year review that is comprehensive, and those changes that you mentioned that relieved burdens for a large number of medium or larger size banking organizations, that in one of the outcomes of that.

Mrs. WAGNER. Thank you, Chair Yellen.

I yield back my time.

Chairman HENSARLING. The time of the gentlelady has expired.

The Chair now recognizes the gentleman from Texas, Mr. Green.

Mr. GREEN. Thank you, Mr. Chairman.

And I thank the ranking member, as well.

And thank you, Madam Chairlady. It is an honor to have you with us. You have done an outstanding job, in my opinion, and you have tried as best as you can to help us to maintain your mandate.

I would just like to mention initially that President Obama has made efforts, and many Members of Congress—David Scott, the Member from Georgia, just mentioned his efforts to bring down unemployment as it relates to African-Americans, more specifically African-American males. Congressman Jim Clyburn has a plan that he calls 10-20-30. The President had a JOBS Act. We have tried to have summer job training programs. So there have been

efforts made to try to bring down the high rate of unemployment in the African-American community as well as in other communities.

But it seems that some of the obstacles include this process or premise that we can engage in expansionary fiscal contraction and that will eliminate some of the problems. There is a fiscal austerity program that has been implemented by my colleagues on the other side. And these things have actually, in my opinion, been a hindrance.

So, given that Congress has not acted appropriately and given that there is this high rate of unemployment in the African-American community, I am calling on the Fed to do a little bit more. And I ask that you do this because I have received an executive summary that I would like to share with you. It is styled, "Experiences and Perspectives of Young Workers."

This is from December 2016, and this summary gives me information, including the following: "The Federal Reserve conducted its first survey of young workers over November and December 2013 to develop a deeper understanding of the forces at play," meaning the reasons why young workers may be having employment problems.

"In December 2015, the Federal Reserve conducted a second survey of young workers to further explore market issues and trends among this population." You go on in this report to indicate some of the outlook expectations. Young adults with a paid job are more optimistic than those without a paid job. Among young adults, steady employment remains more important than higher pay—steady employment, important.

You go on to indicate that many young adults gain early work experience during high school, college, or both. Early employment develops a good work ethic.

And then full-time employment is also correlated with a positive outlook and job satisfaction. So what you have done with this survey, this report, is get some sense of what is happening with young adults.

I have not seen a similar report for the African-American community. Does such a report exist?

If it does, I would like to peruse it. If it does not exist, I believe, Madam Chair, that you have the mandate and the authority to produce such a report.

At some point we have to study, and give empirical evidence, as to why African-American unemployment is almost always twice that of White unemployment. Pick any period of time, pick any President, pick any Administration, and this is a consistent number that you will find. Twice as much as White unemployment.

We need the empirical evidence so that we can use that here in Congress to promote better legislation. Possibly, we have not given the proper legislative answer.

Can the Fed do this? If it has already done it, I would love to read the report.

Mrs. YELLEN. I am not aware that we have already done it, but we have a great deal of research going on in the Fed, and I would encourage people at the Fed and will discuss it with them, trying to look more carefully at this.

Mr. GREEN. Let me assure you that this will be a quantum leap forward to receive empirical evidence from the Fed as to why we have this constant number of 2 times White unemployment. That would be a quantum leap forward.

I am going to beg, Madam Chair, that you do what you can to get this done such that maybe when you are back the next time we can discuss some of these issue related to why African-American unemployment is so high.

And I would also add this: Much of what I read here explains some of what is happening in the African-American community—no summer jobs, no jobs early in life, no opportunity to develop a work ethic. These things are important, and I beg that you help us. Thank you.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from New York, Mr. King.

Mr. KING. Thank you, Mr. Chairman.

Chair Yellen, I am concerned about proposals that would change the composition of the FOMC by removing the vice chairman position and the New York Fed's permanent voting status. That strikes me as misguided, since the New York Fed has responsibilities that no other district bank has, including carrying out our country's monetary policy on behalf of the FOMC and the entire Federal Reserve System.

Could you discuss some of the differences between the New York Fed and the other district banks? And would you say that the New York Fed has unique institutional knowledge of the financial markets?

Mrs. YELLEN. The New York Fed has long had a special and important role in the Federal Reserve System. It has long been the bank that is involved in the markets for us, conducts our open market operations, plays an important role in gathering market intelligence and understanding financial market trends, and because so many especially large banks are headquartered in New York, has very large supervisory staff that plays an important role in our supervision program.

And the decision that the president of the New York Fed should serve as the FOMC vice Chair and vote at every meeting reflects that traditional role. I think it is something that has worked well.

Mr. KING. Not to put you on the spot, but the presidents of the Federal Reserve Banks of San Francisco, Atlanta, Chicago, and Cleveland have all publicly stated that they support the current structure of the FOMC and a permanent seat for New York. Do you agree with that?

Mrs. YELLEN. I think we have a structure that works well, and I am not seeking changes to that aspect of it.

Mr. KING. I will not push my luck, and I will accept that answer.

I yield back.

Chairman HENSARLING. The gentleman yields back.

The Chair now recognizes the gentleman from Missouri, Mr. Cleaver, ranking member of our Housing and Insurance Subcommittee.

Mr. CLEAVER. Thank you, Mr. Chairman.

And thank you, Madam Chair.

Two Saturdays ago in Kansas City, Missouri, where I reside, I held a town hall meeting where the media said 1,000 people showed up, but it was probably about 1,100, on the Executive Order on immigration, and people showed up with great fear. And this past Saturday—I was in Baltimore on Saturday evening and all of a sudden my cell phone started ringing, just one call after another, and there was widespread panic in Kansas City in the clergy community.

Across-the-board, Catholics, Protestants were all concerned—there is a pastors' phone chain, so people were calling each other—that ICE would be at churches on this past Sunday arresting immigrants—undocumented immigrants. It was such a big deal that if your staff or if any of my colleagues' staff would like to check, it is a front-page story in the Kansas City Star on the rumor. All three—well, four—networks did stories, and so they were calling asking me, "How many ICE agents are coming in?"

It was just an awful kind of a thing, and I felt terrible because I was in Baltimore and was unable to be there.

How this connects with you is, I am just wondering, if there is some success at deporting 11 million immigrants, do you think that will have any kind of impact on the U.S. economy? If we were able to just get rid of all of the undocumented workers by next Thursday, do you think there would be any impact on this economy?

Mrs. YELLEN. Immigration has been an important part of labor force growth in the United States for some time now. We are in a period in which one factor responsible for slowing growth is slower labor force growth, and a radical change in immigration would certainly affect the potential of the economy to grow.

Mr. CLEAVER. I will convey that. And the preachers were concerned because they had read about a guy who said, "I was a stranger and you took me in." It was in a book. And so they—based on that, they thought they had an obligation to respond affirmatively.

The other thing is that I think in 2012, the Fed did a study on the housing collapse that we experienced, which triggered the 2008 economic recession. And over the years, for whatever reason, the GSEs have been blamed for the economic collapse, that they set policies that allowed them to give loans—actually they don't give loans; they were buying loans. But they were blamed for the economic collapse.

Your study says otherwise. Can you shorten that into a paragraph?

Mrs. YELLEN. A wide range of problems in the mortgage market, I think, led to the crisis, and the GSEs were probably not the critical part of what caused it.

Mr. CLEAVER. I have too many questions. In all the effort to repeal Dodd-Frank, there is a section in there where the wording is not as strong as I am saying it, but they are essentially saying that we are going to give oil companies the right to bribe elected officials or officials in company—in countries. So we are removing a section of Dodd-Frank so that—so bribery is now a part of—or it is again a part of the way in which U.S. companies operate in foreign countries.

My time ran out. I apologize.

Chairman HENSARLING. The time of the gentlemen has expired.

The Chair wishes to advise Members that I intend to recognize Mr. Royce, Mrs. Beatty, and Mr. Pittenger, and then declare a 10-minute recess.

The gentleman from California, Mr. Royce, the chairman of the House Foreign Affairs Committee, is recognized.

Mr. ROYCE. Thank you very much, Mr. Chairman.

And, Chair Yellen, it's good to see you.

I would like to follow up on a question here about capital. We know on the one hand that over-leveraged institutions are vulnerable to market shocks, and we remember the consequences. If you look back at the over-leveraging of the investment banks, for the large ones 40-to-one. And if you look at the GSEs that were leveraged at that time, over 100-to-one. And that was in the lead-up to the financial crisis.

And so we can see that capital standards must play a role in building resilience in the U.S. financial system. On the other hand, raising capital also has a cost to the economy and a cost in terms of what it does to the potential for growth.

So what we have here is a classic cost-benefit test. There is a benefit to higher capital standards. They reduce the risk of a future financial crisis and bailouts as well as potentially increasing tax revenues.

And while the cost will be borne by borrowers in the form of higher funding costs, and the economy as a whole with less capital formation and a lower GDP, you have that on the other side of the equation.

So as you have said in the past, the cost-benefit analysis is difficult work. And I agree. It is not easy.

But it is not impossible and it is important. In 2010, the Basel Committee did some work on this subject, and also researchers at George Mason recently published a paper on the benefits and costs of a higher bank leverage ratio.

So how do we get to the right number? Should it be 5 percent? The 10 percent in the Choice Act? Or 23.5 percent, as proposed by the Minneapolis Fed President?

There is quite a range there. And I don't expect you to say a number today, but can't you agree that a cost-benefit analysis could help us more effectively require that capital? And I will start with that question.

Mrs. YELLEN. I do agree that in deciding on the appropriate level of capital standards, we are weighing costs and benefits—the benefit of a lower probability of a financial crisis that has incredible high costs against the cost of slightly higher intermediation and borrowing costs. And as you indicated, Basel III was partly informed by the Basel Committee's analysis of those costs and benefits, and the Federal Reserve participated in producing that analysis. And I think it did inform our views as to what a reasonable level of capital requirements would be.

The Minneapolis Fed study that you mentioned also contains cost-benefit analysis and draws the line differently.

Mr. ROYCE. From my standpoint, it seems to me that the Fed would be best suited to conduct the analysis and the research on

this. And as you are explaining here, we have such a range of opinion, although we agree on the basic concept here.

So my question would be, short of us mandating the Fed to do it, would there be a way for you to try to move forward and approximate what that ratio should be?

Mrs. YELLEN. Through different aspects of it. As I said, we did do cost-benefit analysis, and it informed our judgments at the time. You have referred several times to a leverage requirement—

Mr. ROYCE. Right.

Mrs. YELLEN. —and I think our understanding of the risks facing banks lead us to think that a simple leverage requirement would not be an adequate way to determine capital. In particular, a simple leverage requirement treats the risk associated with the U.S. Treasury and a junk bond identically, and we think that capital requirements need to be risk-sensitive with a leverage ratio serving as a backup—

Mr. ROYCE. No, I understand. It might not be sufficient, but in terms of having it be a component, it seems to me that—well, there is another question I wanted to ask you, too, and that is yesterday you told Senator Crapo that the goal of bringing private capital back into the mortgage market is important and that you hope that if there are guarantees in the secondary mortgage market, that they would be recognized as priced appropriately.

It is my understanding, then, that you believe that the pre-GSE model of private gains and public loses did not price the government backstop appropriately.

Mrs. YELLEN. I think that is correct.

Mr. ROYCE. Thank you.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentlelady from Ohio, Mrs. Beatty.

Mrs. BEATTY. Thank you, Mr. Chairman, and Ranking Member Waters.

And thank you so much for being here, Chair Yellen. In the form of me trying to be consistent with questions, I would like to repeat a question that was asked by me before. Certainly, as you know, I have a strong interest in making sure that we have equality and equity as it relates to employing women and minorities.

So I want to start with first thanking you for responding in writing, and not only in writing but detail, to that question. I know in the Senate hearings that Senator Brown also posed some questions as we look at the Federal Reserve Bank and what is happening.

I know we have a couple of openings since our last conversation here, but let me just say if there are any additional things for the first part—I have two questions—that hopefully you can share we are, if we are making any headway. Because I also pulled some facts, and according to the Fed Up campaign at the Center for Popular Democracy, it states that the board of directors was 83 percent White and 70 percent male.

Under the Federal Reserve Act, the Board of Governors has the authority to appoint class C directors. Can you describe that process for appointing class C directors or give me any brief update on where we are? Because I am thinking about reintroducing my bill that was patterned after the Rooney Rule with the Beatty Rule,

that if there is an opening all we are asking is that you have a pool of candidates in there.

Mrs. YELLEN. We are very focused on achieving diversity in our class C directors—more broadly, on the boards of directors of all of the Federal Reserve banks and their branches. We engage in ongoing at least yearly evaluations of the progress of the reserve banks in achieving diversity. We insist on recommendations from the reserve banks that will enhance diversity; make sure that there is adequate representation of women and of minorities; that we have sectoral diversity, as well; that consumers, labor, and nonprofits are represented.

It is a constant focus and we give feedback to the banks to inform their search for directors. I do believe we have made progress on it and achieved greater diversity. I will say that it is a very high priority for us.

Mrs. BEATTY. Thank you very much.

Chair Yellen, I just learned that last month you did something which seems unique or different. The Federal Reserve held a teachers town hall meeting. And I thought that very interesting and very pleasing because financial literacy is something to which I have dedicated probably the last 2 decades of my career.

And I am very pleased to say, Mr. Chairman, and Ranking Member Waters, that I have been appointed as the new co-Chair of the Financial and Economic Literacy Council, with my Republican colleague, Steve Stivers.

Was there anything in this town hall that you can share as it relates to the financial literacy or it relates to something we should be looking at? And maybe this could be a bipartisan thread and we could get your staff to laugh or smile with that because it would be so positive that we would have a Democrat and a Republican working together.

Mrs. YELLEN. Perhaps we can give you some more detailed feedback if that would be helpful. I mainly answered questions that a group of economics educators had for me about what they should be teaching their students about the Federal Reserve. I was asked about diversity in the economics profession and what could be done to foster diversity and shared some thoughts on that topic and why it is that perhaps women and minorities are not attracted into economics, even as a major in college, in the numbers that one would want and expect.

But on financial literacy, maybe we can give you some more detailed feedback.

Mrs. BEATTY. Okay. Thank you so much.

Mr. Chairman, I yield back.

Chairman HENSARLING. The gentlelady yields back.

The Chair now recognizes the gentleman from North Carolina, Mr. Pittenger.

Mr. PITTENGER. Thank you, Mr. Chairman.

Good afternoon, Chair Yellen.

Chair Yellen, there has been much said today regarding the different economies, what is—I heard my good friend Mr. Meeks in his performance, and basically a diatribe of market-driven economies and lauding the highly regulatory policies of this last Administration.

But in North Carolina, we kind of have a way of conveying this. It is like trying to dress up a pig and put perfume on it. It doesn't really look as good as it is. The outcomes really reflect something different.

He had mentioned that there had been 16 million jobs created from this economy. And when you look at 8 years, that is 200,000 jobs a month.

So comparing that to the time that I lived in Washington back in the 1980s when Ronald Reagan was President, he inherited an economy that was very weak. There was 20 percent interest rates, high inflation, high unemployment.

And after 2 years with an independent Fed, reduced regulatory burden, and reduced tax threshold, the economy grew and began to grow exponentially—300,000 then 400,000 and 500,000 jobs a month; 1 month a million jobs. And we were growing at one point at 6 percent growth.

We look now at an economy that hasn't even reached 3 percent economic growth, the only Administration since World War II that hasn't been able to achieve that objective.

I would say to you, Chair Yellen, given that and really the number of American people who are just living at the margins, just around the kitchen table, they are struggling. They came out in droves in this last election because they are upset. It hasn't worked.

Do you feel that there are different policies that should have been made in hindsight, that you missed something? In business, we have a way of assessing what we do right and what we do wrong. But have we missed the mark?

Have we not—we clearly didn't achieve the objectives that were intended. Low-income, minority people, frankly, that demographic group have moved the least up the economic ladder than any group in the country. And certainly that was a focus of the folks you were trying to help.

So I would really like to get your analysis of what we missed. And is there something in our monetary policy we could have done differently? How about regulations and oversight? What would you do different today if you were given the chance?

Mrs. YELLEN. I think that the trends that you described that have left so many Americans feeling frustrated with the labor market and their economic circumstances and success date back to well before the financial crisis, probably back to the mid-to late 1980s. And we saw the character and composition of jobs changing in the United States.

Mr. PITTENGER. With all due respect, Chair Yellen, if I could interrupt, we don't have a lot of time. This recession, the President, he was only in recession 2 months out of his 32 months. So, he had a chance. And these policies had a chance, and yet they didn't work.

I would like to ask you a couple of other things, though.

Relative to community banks, you made the statement that you are concerned about what has happened with community banks in this country. In North Carolina, we have lost 40 percent of our banks since 2010. That is a major impact on our economy and access to capital and credit.

Do you believe that there should have been or should be today—would you advise us to reduce the regulatory burden on these community banks?

Mrs. YELLEN. Yes. And I think we should be heavily focused on using every tool available to us to reduce regulatory burden on those banks.

We ourselves and with other banking agencies have taken a number of important steps, and I think it is—and we will continue—

Mr. PITTENGER. But you would advise the Congress to be fully engaged in trying to—

Mrs. YELLEN. I would be, yes.

Mr. PITTENGER. Yes, ma'am. Thank you very much.

Chair Yellen, Secretary Lew argued that China has become, in his words, more adept at communicating its policy path in its analysis of its own economy, which will avoid confusion and instability in the global economy. Do you agree with Secretary Lew on his assessment of China?

Mrs. YELLEN. I am not privy to all the detail that he may have given—

Mr. PITTENGER. But in principle?

Mrs. YELLEN. —on that.

Mr. PITTENGER. The principle is there, the greater oversight, communicating policies. Do you think that is a healthy thing?

Mrs. YELLEN. I do think it is a healthy thing,

Mr. PITTENGER. In like manner, would you say that if it is true for China that it should be true also for our country, for our Fed, that maybe we could be more up front and the public could understand our policies? We have the FORM Act that lays out commonsense steps to achieve this, and I would just like to know your perspective on that. There are many Federal Reserve officers who concur, Nobel Peace Prize winners that agree, as well.

Mrs. YELLEN. Transparency is an important objective, and we are always looking for additional steps. I think it has been improved. I think, as you know, I am not a supporter of the FORM Act that would chain the Fed to a simple rule. I think that would result in poor economic performance. And while understandability and predictability are important goals—

Mr. PITTENGER. My time has expired, Chair Yellen.

Mrs. YELLEN. —what matters most at the end of the day is economic performance—

Chairman HENSARLING. The time of the gentleman has expired.

The Chair will now call a recess of the committee for 10 minutes. Members are advised that we anticipate reconvening in 10 minutes.

We intend on adjourning the hearing at approximately 2 o'clock and we anticipate one intervening vote series. The committee stands in recess.

[recess]

Chairman HENSARLING. The committee will come to order. Members are requested to take their seats.

The Chair now recognizes the gentleman from Connecticut, Mr. Himes.

Mr. HIMES. Thank you, Mr. Chairman.

Chair Yellen, thank you for being with us today. I always appreciate your testimony and the very good work that is done and summarized in this report to us.

I have a couple of questions for you, starting with, I want an opportunity just to sort of reflect on and maybe ask a question about the economic narrative that we are getting and that we have gotten for so long from the Majority.

I was here 8 years ago, sworn-in, in a month when the economy lost almost three-quarters of a million jobs. We were handed—I think the technical economic term would be a "dumpster fire" of an economy, and took a number of measures, including the Recovery Act and then regulatory measures to stabilize the financial sector, which was on its knees. Every single one of those measures, of course, was opposed by my friends on the other side of the aisle.

My question, though, is, we are now accused of—you are accused and we are accused, and I think we are probably properly accused of not doing enough to spur economic growth. The Fed certainly is. And we have heard that.

Apparently, growth of 2 percent is not the 4 percent promised by President Trump. And apparently we could have done better.

I guess my question to you is—my memory of economics is that economic growth in the end is a function of population growth and productivity growth. So I guess my question is—and I have looked at other industrialized countries' OECD growth rates, and actually the growth of 1.9 percent over time is not inconsistent with other industrialized countries.

So I wonder, as an economist, whether you agree that our growth rate has been in some way artificially held back or whether we are just sort of operating the way economies operate, growing at just below 2 percent?

Mrs. YELLEN. When an economy suffers a deep recession and unemployment is very high, output is well below the economy's potential, and it can grow more rapidly than the pace dictated by population or labor force and productivity. But once the economy is operating at its potential and unemployment is in the neighborhood of full employment, as it is now, then I would certainly agree that it is labor force growth and productivity that dictate the pace of growth.

Unfortunately, that looks like it is a little bit under 2 percent for the U.S. economy. Labor force growth has slowed and productivity growth has been very disappointing. And to speed that up we would have to see an improvement in one or both of those things.

Mr. HIMES. I have been reading these reports since I have been here, and the reports have always listed factors that have perhaps dampened growth. And I remember the housing hangover was cited some years ago, uncertainty, and issues of aggregate demand.

This report has never highlighted regulation as a material—and I do mean material; I understand that overregulation can, in fact, have a quashing result—but this report has never cited regulation as a material factor in dampening U.S. growth.

Is it the opinion of the economists at the Federal Reserve that regulation has really been a material brake on the U.S. economy in the last 8 years?

Mrs. YELLEN. Investment spending has been quite low, and we have tried to understand what some of the factors are that are responsible for it. Businesses in surveys do cite regulation, taxes, and uncertainty as factors that are holding back investment.

So we understand it could be contributing to slow growth in investment spending, but there are also other factors, namely the economic growth overall has been slow, sales growth for those firms have been slow, and that, I think, has been important as well.

Mr. HIMES. Thank you.

Last question, I don't have a lot of time. I am a big believer in preserving monetary independence or independence for the monetary authorities. You have been vocal on this, most notably in your letter of November of 2015.

I wonder, in my remaining time can you talk a little bit about some of the initiatives—Audit the Fed, the FORM Act in particular, GAO access to the Fed? Do you think that these initiatives could over time compromise the independence of the FOMC and of our monetary policy?

Mrs. YELLEN. Yes, I do. And this goes beyond the issue of a rule in the FORM Act. It goes to asking the GAO to come in on a real-time basis and make policy judgments that would second guess the decisions of the FOMC.

I think that involves very detailed intervention in monetary policymaking the compromises independence, and I think central banks all over the world have recognized that an independent central bank that can focus on the long-run health of the economy, maintaining low and stable inflation and steady employment growth, gives rise to a better economic environment and has been—

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Florida, Mr. Ross.

Mr. ROSS. Thank you, Mr. Chairman.

Chair Yellen, it's good to see you again. And I want to put in a word, as I have done in the past, with you concerning the mom-and-pops, the fixed-income people who have really suffered a lot in their savings and eating into principal. And I am hoping that monetary policy will be such that they will have an opportunity that they can survive again and not just those on Wall Street.

My question to you is, and following up on my colleague, Mr. Himes, in the FORM Act we passed, the Centennial Monetary Commission Act, which I am sure you are familiar with. It was Chairman Brady's idea to have the commission to overlook oversight of the Fed. In fact, the committee would highlight opportunities for improvement.

Given our economy's somewhat unconventional and anemic recovery over the last 6 years, would you agree that it might be a nice idea to have such a commission as a centennial commission for oversight?

Mrs. YELLEN. I don't think such a commission is needed. It is, of course, up to Congress to decide if you want to look at the structure of the Federal Reserve, but my own assessment is that the Federal Reserve has performed well. We have adapted to changes and—

Mr. ROSS. And if they have there is nothing really to be concerned about an independent commission reviewing. If you have set

the Fed on the path that you have chosen, then I think that this would just confirm your suspicions that you are on the right path, would it not?

Mrs. YELLEN. It is a decision that is up to Congress if you want to make that. I would urge you to decide what the problem is that needs to be addressed, and I believe we have a structure that works well.

It was one that was decided on by Congress, and I think we have adapted to changes in the economy over 100 years. So our structure is not broken, but it is—

Mr. ROSS. So you don't think it is a good idea to have an extra pair of eyes, just to see?

Mrs. YELLEN. We have lots of pairs of eyes and lots of—

Mr. ROSS. How far they can see—

Mrs. YELLEN. —analysts all over who are looking at the Fed structure, and it is not a topic that hasn't received a great deal of attention.

Mr. ROSS. Yet.

Let me move on to another topic with regard to State insurance regulation. Despite its proven track record, our State-based insurance regulatory structure has faced many challenges in recent years, especially with dealing with the IAIS and international standards.

Today, we are faced with potentially more intrusion in insurance regulation by the Federal and international financial regulators. With your engagement in international negotiations, I have just a few questions.

One, would you agree that our State-based form of regulation in insurance, risk-based capital, is probably doing its job and is doing a good job?

Mrs. YELLEN. State-based regulation is very important. Its focus has always been on protecting policy holders, which is one important focus—

Mr. ROSS. In fact, we have probably, I think, what is recognized as the best system of regulation in the insurance industry through our State-based programs. Would you agree?

Mrs. YELLEN. I think those programs have been successful. But we certainly saw in the financial crisis that we had a large insurance company that was heavily involved in capital market activities that were a source of systemic risks. And I do think—

Mr. ROSS. And that was a federally regulated subsidiary of AIG, though, that had that problem, and not necessarily State—we have never seen a run on insurance companies, so I guess that is my concern, because we have a good system in place.

And with that in mind, you have a seat at the table of the International Association of Insurance Supervisors and the Financial Stability Board. Are you now working with State regulators, insurance regulators, commissioners to develop a consensus before entering into negotiations on an international basis?

Mrs. YELLEN. They all participate in that forum, as we do, and our participants meet and confer with them and try to understand what is in the interest of U.S. insurance firms and to try to influence—

Mr. ROSS. And I would hope that you take the position as an advocate on behalf of our insurance regulation system.

Mrs. YELLEN. We are always trying to see other countries establish regulatory frameworks—

Mr. ROSS. Similar to ours?

Mrs. YELLEN. —that will be consistent with ours and result in strong regulation, but a level playing field for our firms.

Mr. ROSS. Thank you, Chair Yellen. I appreciate that.

And I yield back. Thank you.

Chairman HENSARLING. The gentleman yields back.

The Chair now recognizes the gentleman from Maryland, Mr. Delaney.

Mr. DELANEY. Thank you, Chair Yellen, for being here and for your wonderful service to the country.

Mrs. YELLEN. Thank you.

Mr. DELANEY. I have three questions. I will try to get them out all up front so you can think about them.

The first is, if policies coming out of Washington across this next several years fall into the category of protectionist by nature, putting through unpaid-for tax reductions that increase the deficit and foreign policy that might cause foreign investors to recalibrate down their investment in the United States, how much of an impact—negative impact—do you think that will be on long-term economic growth? That is my first question.

My second question is about the labor market. Do you think the biggest issue in the labor market is employment, or jobs, or is it pay? What is the real structural problem with the labor market right now? Is there not enough jobs or is the pay not good enough, in your opinion?

And my third question is, as you think about the Fed balance sheet and running off the mortgage investments that you have, has there been discussions within the Fed about considering other asset classes, such as infrastructure asset classes, if eligible bonds were to be created that perhaps the Fed could invest in?

So those would be my three questions.

Mrs. YELLEN. Your first question pertained to protectionism, the deficit in capital flows and what impact they would have on growth?

Mr. DELANEY. Yes.

Mrs. YELLEN. And honestly, without knowing more about the details of the policies it is really difficult for me to render a judgment.

In general, we understand that many different economic policy shifts are under consideration, that they may well affect economic growth, inflation, have repercussions for our policy stance. But without knowing something more about the timing, composition, and details of those changes, I honestly can't—there are many different effects both positive and negative.

On labor, in some sense I think we have enough jobs, and that is what a 4.8 percent unemployment rate tells you is we have created a lot of jobs, but pay in real terms is not rising rapidly. And the composition of those jobs over many decades and even more recently continues to shift in ways that are leaving particular classes of workers disadvantaged.

Mr. DELANEY. So if I could, Chair Yellen, this is my view, that we have more of a pay issue than a jobs issue, and when you look at what is happening to the labor market, particularly the effect of technological innovation, do you see this pay issue being a persistent enduring issue that we really do need to think differently about?

Mrs. YELLEN. We have had very slow growth in real income. And going back to the late 1980s, the bottom—probably the bottom half of the income distribution in terms of pay have seen no real wage increases.

Disproportionate gains have gone to those at the high end of the income distribution. That goes to the composition of jobs and the trends that different jobs have in terms of pay, and I think it is a serious problem and what we are hearing from dissatisfied Americans.

Mr. DELANEY. And then as it relates to the Fed's balance sheet, which you don't really need to shrink theoretically. You are not structured like a normal bank, and as you run off your mortgage investments in your current portfolio have you thought about other asset classes for the Fed to invest in that might be more—

Mrs. YELLEN. We are restricted to Treasury and agency debt. We have not—

Mr. DELANEY. Have you ever discussed internally what other investments might allow you to pursue your mandate?

Mrs. YELLEN. I have mentioned that other central banks have broader authority to purchase different assets and have sometimes used that authority. We have not. We are not asking for that authority. I have said that if Congress were to ever to consider changing that authority there would be both costs and benefits to consider.

So I do want to be clear, it is not something the FOMC is looking—

Mr. DELANEY. Has it been successful in other countries, do you think?

Mrs. YELLEN. Excuse me?

Mr. DELANEY. Has it been a successful policy in other countries that have done it, pursued it?

Mrs. YELLEN. I have not seen detailed studies, but arguably yes, it may have been.

These are only policies that are used in exceptionally difficult times. It is not normal monetary policy in countries like Japan or the euro area that have used it—have done it in times that called for exceptional monetary policy accommodation.

Mr. DELANEY. Great. Thank you, Mr. Chairman.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Oklahoma, Mr. Lucas.

Mr. LUCAS. Thank you, Mr. Chairman.

Chair Yellen, I, probably along with maybe a half a dozen of my colleagues here, date back to the old days of when this was the Banking and Urban Affairs Committee. And we used to have these great glorious discussions about Karl Marx and Adam Smith. It was just awesome in the old days.

But you know, it has always been my policy to try and focus on the issues that have a direct impact on the constituents and the people I serve back home. So in that spirit, I would like to ask you a question, and if you can answer it I would be most appreciative.

I would like to turn to the Fed's role in uncleared swaps markets for a moment since Dodd-Frank had an effect on that above and beyond the jurisdiction of the committee, but also the Financial Services Committee.

On March 1st of this year, participants in that market will be required to post variable margin with each other. Updating those existing swap agreements for these variable margins involve a complicated process according to market participants. It takes a lot of time.

I saw a figure that only 0.16 percent, less than two-tenths of a percent, of all swap agreements have been updated to meet these various margin requirements. And that is with a deadline only 2 weeks away.

That instability concerns me because many of the smaller end users enter in the swaps markets to legitimately hedge against the market and thus confronting these legal puzzles with few resources. Turning to your role in this process, 2 days ago the CFTC instituted a temporary grace period, and under that relief, market participants affected by these requirements have a 6-month period for compliance. They must be ready by September 1st.

In addition, regulators in Asia have provided a similar grace period and the European regulators, it seems, have stated they are open to similar wiggle room on the March 1st deadline. With all of that, can you share with me whether the Fed intends to coordinate with the CFTC on providing relief to entities under its jurisdiction that are a part of this market?

Mrs. YELLEN. We are aware of the problems that you describe. We have been monitoring trends in compliance very closely. We are in touch with some of the firms that are involved, and we will be in discussions with other banking regulators to discuss what response may be needed to this.

Mr. LUCAS. But it is being analyzed that the circumstances are evolving as they are and the potential impact on the participants. From my perspective, it is those end users that matter to me.

And I guess I would have to say thank you for taking that note, and I hope, like the CFTC and the Asian regulators and perhaps our European friends, we will see a similar response.

With that, I think, Mr. Chairman, in the brevity I will yield back the balance of my time.

Chairman HENSARLING. The gentleman yields back.

The Chair now recognizes the gentleman from Washington, Mr. Heck.

Mr. HECK. Thank you, Mr. Chairman.

Chair Yellen, thank you so much for being here.

Let's talk housing. Often—in fact I would say usually—the housing market is kind of the big swing industry in the economy. In recessions you cut interest rates and that leads more people to buy homes, developers cut ground, building trades hire up to engage in all of that. The people who buy the homes go into the local Lowe's

and buy furniture or whatever, and it usually has a materially stimulative effect on the economy.

Not this time, certainly compared to the past. Housing starts are now the same they were at the depth of the 2001 recession; and in fact, they are near where they were at the bottom of the great savings and loan crisis about a quarter of a century ago.

So my question is, Chair Yellen, as you raise rates do you worry about choking off an already weak housing recovery, or do you think housing is just less sensitive to interest rates than it was pre-bubble?

Mrs. YELLEN. I think there is still sensitivity there of housing to interest rates. And of course, this was a very different cycle in which it was housing-related problems that were part and parcel of the crisis. And so when we cut rates we didn't get the usual response that you would have of housing quickly responding positively to the rate cut.

So, as I mentioned in my testimony, higher interest rates—and mortgage rates have gone up some over the last several months—may play a retarding role in restricting the recovery of housing. But the other positive side of it is we have good employment growth, income growth; consumer spending is solid; house prices have been rising. And all of those are positives.

So on balance, we have seen a very slow but continued recovery in housing, and I would expect that to continue even in the context of somewhat rising mortgage rates. And they are very low, by historic standards.

Mr. HECK. So you mentioned wages in passing. I will mention before I ask my next question, wages have ticked up in growth, but only to about 2.5 percent.

The last recovery, they were at 4 percent. I think America is still wanting to know when they are going to get a raise, but that is not my question.

One of the things about the housing market that I find really confusing is that prices seem to be rising in markets all over the country. In many cities they have even eclipsed where they were before the bubble.

In the Chair's home State, where, frankly, some would characterize land as infinite and home prices have historically always followed inflation, we are now seeing significant real increases.

It used to be that markets would more quickly balance supply with demand, and now they seem to have sustained imbalances. Prices keep rising.

I am privileged to chair a task force that is going to take a look at this more closely, and I am really interested in your perspective. My basic question is why are we seeing such weak home construction, despite the fact that we have rising prices?

Mrs. YELLEN. That has been a surprise as well, why construction remains so weak with house prices—

Mr. HECK. And the answer is?

Mrs. YELLEN. We do have robust growth in multifamily. Many young people, millennials, are delaying buying homes, and I think that has impacted single-family construction. We have seen very depressed pace of household formation, a remarkably large fraction of young people who continue to live with their families.

And even as the economy has recovered, household formation has remained quite depressed for reasons that are difficult to understand.

Mr. HECK. You seem to be implying that they are—they want to be living in the basement, as opposed to they are unable to get out of the basement.

Mrs. YELLEN. We have seen that continue even as the job market has strengthened and unemployment rates have come way, way down. So it is historically low. From builders we hear about shortage of workers, their skilled workers, and buildable lots. And there may be some supply issues there, as well.

Mr. HECK. I yield back, Mr. Chairman.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Illinois, Mr. Hultgren.

Mr. HULTGREN. Thank you, Mr. Chairman.

And thank you, Chair Yellen. I appreciate you being here today.

I know we are in agreement on the need to prevent bailouts of our Nation's financial institutions from ever happening again. However, the Fed has implemented some controversial policies that I am concerned may have some unintended consequences that, in fact, could increase systemic risk.

AEI Resident Scholar Paul Kupiec has noted that coordinated supervisory stress tests encourage a group-think approach to risk management that may increase the probability of a financial crisis. If the systemically important banks are all following the same capital requirements, and they all are being tested against the same stress scenarios, then isn't the Fed creating a herd of banks that can easily be pushed off the cliff? Don't we want a mechanism that is truly capable of increasing financial resilience, such as real-market discipline?

Mrs. YELLEN. I haven't read Paul's work, but I think that is an issue. We don't want group-think in management of risk at banks.

We want banks to be focused on understanding their own idiosyncratic risks and modeling it. And one reason to avoid what we would refer to as a model mono-culture, which is this sort of herd approach, we have consistently resisted sharing with the banks subject to stress tests our models.

One consideration, gaming it is changing their portfolios so that they look good on our models is one reason—

Mr. HULTGREN. I want to ask you about that quickly, if I could.

Mrs. YELLEN. —but we want to make sure that they don't all say, "Okay, this is the way to manage your risk." We want them to develop their own models.

Mr. HULTGREN. Yes. Governor Tarullo has emphasized that the Fed does not want banks to game the model, as you say, for Fed stress tests.

Can you give us an example of how a bank would game a stress test?

Mrs. YELLEN. Understanding what the particular areas of risk and scenarios might look like and how we would evaluate them in our models could induce banks to understand that they could make portfolio changes that would enable them to fare better.

Mr. HULTGREN. I guess, following up on that some more, if banks were able to game the Fed's stress test, wouldn't they have to change their risk profile in a manner that addresses the very concerns that you and your colleagues have about systemic risk? And don't you want them to make chose changes?

Mrs. YELLEN. No, not necessarily, because banks have their own individual sources of risk.

Mr. HULTGREN. It seems ironic to me. It would seem transparency in how stress tests are designed would help you achieve your objective while at the same time reducing regulatory costs.

Since the enhanced supervisory framework of financial institutions was put in place, what analysis, if any, has the Fed done to determine if the increased compliance costs to financial institutions is commensurate with the risk? And how about an analysis on the ability of these banks to provide access to credit?

Mrs. YELLEN. Are you talking about with the stress tests?

Mr. HULTGREN. Right.

Mrs. YELLEN. We have completed a 5-year review of our stress tests. The GAO has also done a review of our stress testing methodology. And, as was noted earlier today, we recently finalized a rule that takes over 20 smaller institutions and exempts them from the qualitative portion of our program.

We did conclude that the regulatory burden exceeded the benefits and changed our rule to diminish regulatory burden in what I think is a significant and responsive way.

Mr. HULTGREN. Earlier in the hearing today, you said that the Fed is thinking about incorporating a G-SIB surcharge in CCAR before Governor Tarullo departs. A new Vice Chair for Supervision nomination is likely weeks away, so why is the Fed moving ahead on these changes before the nomination and confirmation of this individual?

Mrs. YELLEN. I don't know what the timing is going to be of those changes. I think we would want to make sure that we had notice out and an ability to finalize such changes probably before our 2018 stress tests go into effect.

We look forward the appointment of a Vice Chair. If we go at it with the—

Mr. HULTGREN. I think it makes sense to hold off some, just—

Mrs. YELLEN. —with the notice of proposed rulemaking—

Mr. HULTGREN. I have 20 seconds left. Let me ask one more, quickly.

There are currently three White House orders affecting potential new rulemakings. Additionally, last year the GAO found deficiencies with stress testing already affecting growth. Do you agree that the Fed should act cautiously regarding any CCAR changes?

Mrs. YELLEN. I'm sorry. What?

Mr. HULTGREN. Do you agree that the Fed should act cautiously regarding any CCAR changes?

Mrs. YELLEN. In line with GAO recommendations, did you say?

Mr. HULTGREN. Last year, the GAO—my time has expired. We will follow up with a letter.

Chairman HENSARLING. The time of the gentleman has expired.

I wish to inform Members that votes are currently pending on the Floor. I anticipate clearing two more Members, having a brief

recess, and then reconvening. Members are encouraged to come back promptly after votes.

The gentleman from Pennsylvania, Mr. Rothfus, is recognized.

Mr. ROTHFUS. Thank you, Mr. Chairman.

Chair Yellen, last year I asked you about the custody banks and their concerns about the supplementary leverage ratio. As you acknowledged, these institutions face unique challenges in meeting requirements like the SLR.

Former Governor Tarullo has made similar statements acknowledging the problem. At a conference in December he stated that, "As part of our efforts to tailor our regulations according to the business models of firms we are considering ways to address the special issues posed for the large custody banks by certain elements of our regulatory framework."

I appreciate the Fed's understanding of the unique regulatory issues custody banks face, and I would like to continue to work with you on the issue. Can you tell me what progress the Fed has made on addressing this issue over the last year?

Mrs. YELLEN. I can't give you details but I can tell you that we have continued to engage in conversation with those banks to try to understand in detail the issues they face and possible strategies that they or we could undertake to mitigate some of those burdens.

Mr. ROTHFUS. Thank you.

Mrs. YELLEN. I promise we will continue to work with them.

Mr. ROTHFUS. Thank you.

As you know, the President recently issued the Executive Order laying out core principles for regulating the U.S. financial system. This order includes a list with the following core principles: enable American companies to be competitive with foreign firms in domestic and foreign markets; and advance American interests in international financial regulatory negotiations and meetings.

When Senator Crapo asked you about the core principles yesterday you expressed support, saying, "I certainly do agree with the core principles. They enunciate very important goals for our financial system and for supervision and regulation of it, and I look forward to working with the Treasury Secretary and other members of FSOC to engage in this review."

I appreciate your support for the principles, but I would like to get a better understanding of how you foresee the Fed putting them into action. Specifically, how should the United States alter its approach to international insurance regulatory discussions in response to these core principles?

Mrs. YELLEN. We have been involved with State regulators, the NAIC, the Federal Insurance Office, and others in international—

Mr. ROTHFUS. What about with designating G-SIBs? Would allowing a firm that is not a SIFI in the United States to be designated as a global systemically important insurer be consistent with American interests?

Mrs. YELLEN. Our designation of firms for special supervision for SIFI status in the United States takes account of their threats to U.S. financial stability. In foreign countries where those firms operate, the regulators are also concerned about their impact on financial stability in their countries. And the two perspectives may not always line up.

Mr. ROTHFUS. You testified earlier today that the FORM Act would "chain the Fed to a simple rule." But the FORM Act permits the Fed to deviate from the rule, does it not?

Mrs. YELLEN. Every deviation involves review by GAO of our decision-making—

Mr. ROTHFUS. Wouldn't every deviation, though, provide an opportunity to educate the American people and Members of Congress as to what you are doing?

Mrs. YELLEN. I believe it is important to provide that education, and I try to do so in my testimony, and press conferences, and our minutes, and our monetary policy report.

Mr. ROTHFUS. And you could do that to explain your deviation from the rule. Because right now we are looking at the policy over the last 6, 7, 8 years, and it is like, I blew up the balance sheet, and all I got was 6 years of substandard growth.

Mrs. YELLEN. I am prepared to explain our policies. And as I have said previously, we routinely look at rules as useful guidelines. I recently gave a speech just a few weeks ago at Stanford where I explained in detail—I would really recommend it to you—reasons why the recommendations of some simple rules would not have been a good guide for us over the last several years or currently.

Mr. ROTHFUS. But you would still be permitted to deviate from them.

Mrs. YELLEN. I think that bringing GAO into routine real-time reviews of our policy decisions simply compromises the independence of monetary policy.

Mr. ROTHFUS. Let me shift gears a little bit. The CFPB receives its funding from the Fed, correct?

Mrs. YELLEN. I'm sorry?

Mr. ROTHFUS. The CFPB receives its funding from the Fed?

Mrs. YELLEN. Yes.

Mr. ROTHFUS. Does the Fed have any oversight responsibility for the CFPB?

Mrs. YELLEN. No.

Mr. ROTHFUS. Has the Fed ever denied a disbursement request for the CFPB?

Mrs. YELLEN. No.

Mr. ROTHFUS. I guess I am running out of time, but you talked about the 2 percent target for inflation. And we talked a little bit about some financial literacy; you had a teachers' town hall.

I am curious, do teachers in financial literacy teach that a pound of ground beef at $6 is going to cost $6.60 in 5 years, or a gallon of milk that costs $4 now is going to cost $4.40 in 5 years if you hit that target?

Mrs. YELLEN. I don't know what—

Chairman HENSARLING. The time of the gentleman has expired.

Mr. ROTHFUS. I yield back.

Chairman HENSARLING. The Chair now recognizes the gentleman from Colorado, Mr. Tipton.

Mr. TIPTON. Thank you, Mr. Chairman.

Chair Yellen, thank you for taking the time to be here.

When we previously had an opportunity to be able to visit you had cited in the past that you recognize the trickle-down effect of

regulations that are going on. And I have a primary concern of community banks. And I believe we share—you believe that community banks are important for the economic health of the country?

Mrs. YELLEN. I do.

Mr. TIPTON. And in recognizing that, and in view of your past statements, I will speak actually to my colleague, Mr. Himes', comment when he was referring to your report. He had noted that he is concerned that you are not addressing or you have not addressed regulatory burden in regards to your report. You had recently had a meeting in St. Louis, I believe in September, being able to meet with a variety of people in the banking industry, and they had cited and discussed with you at this conference the number one reason for community banks to stop offering some products was an ongoing concern of the regulatory burden.

So I guess my question to you is, you have stated to us in the past that you recognize the trickle-down effect. You have heard from community bankers that you cite or is important to our economy and the country. What is the Fed doing to actually help resolve some of the challenges that they face?

Mrs. YELLEN. We have taken many steps that I think—based on my regular meetings with community bankers—they see as quite positive.

We are coming into many banks less frequently, extending exam cycles. We have heard from them that having large groups of examiners on their premises for long periods of time is burdensome, and so we are giving them the opportunity to let us do much more work off site. We are risk-focusing our exams so that for well-managed, well-capitalized firms, we are spending less time and focusing on real sources of risk to those banks.

We are reducing the frequency of consumer compliance exams for well-run and well-managed banks. We have gone through the Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA) process. There are a number of changes that are going to come out of that that will simplify burden. We are looking at reducing—

Mr. TIPTON. If I may, since we are going to run out—and I appreciate the extensive list that you are putting out, but I have to be able to actually look at the results. When we go back to the September meeting that you had had with community bankers, they are still citing regulatory compliance.

I just received an e-mail yesterday from a small bank on the western side of Colorado. And going a little bit to your unemployment numbers, I guess the good news is they created three jobs. The bad news is for that small community bank, it is all in compliance.

So are we really seeing the results for the community banks in terms of everything that you were just citing? We continue to hear out of our community banks it is regulatory burden that is inhibiting their ability to be able to provide the liquidity, to be able to grow the communities, and to be able to create jobs.

Mrs. YELLEN. Community banks labor under a number of burdens, not all of which reflect compliance burden. But I think that if you—

Mr. TIPTON. But it is the number one thing that they cite to us.

Mrs. YELLEN. We do meet regularly with a council, so-called CDIAC, community development, community banks, and discuss with them how they experience our supervision. And I would say—

Mr. TIPTON. Can we look at maybe just some outcomes? How many new bank charters were requested last year?

Mrs. YELLEN. There are virtually no new bank charters.

Mr. TIPTON. No new bank charters. How many consolidations were there?

Mrs. YELLEN. There are a lot. They are a fundamental—

Mr. TIPTON. How many shut down?

Mrs. YELLEN. I don't know the numbers of how many shut down.

Mr. TIPTON. I know that you understand the problem. I guess what I am questioning is, are the results actually yielding the desired result?

We have the lowest labor participation rate in this country in decades. We have more small businesses that are shutting down. You had cited that NFIB report, hey, they aren't really even asking for loans.

But you cited earlier today that they are looking for alternative methods, going to second mortgages on homes, to be able to get a loan out of the bank. So is this impacting the economy, job creation, and the overall health for rural America, which is of deep concern to me?

Chairman HENSARLING. The time of the gentleman has expired.

The committee stands in recess.

[recess]

Chairman HENSARLING. The committee will come to order.

The Chair now recognizes the gentleman from Texas, Mr. Williams.

Mr. WILLIAMS. Thank you, Mr. Chairman.

And thank you, Chair Yellen, for your testimony this morning.

Mr. Chairman, before I begin my questioning I wanted to briefly discuss Chair Yellen's testimony from yesterday's Senate Banking hearing and some comments by Senator Elizabeth Warren, whom, I might add, must live in a different business climate environment than I do; and also, for the record, remind my colleague on the other side that when we talk about hitting homeruns out of Fenway Park, the fences are very short in Fenway Park.

[laughter]

Senator Warren, in an exchange with you, Chair Yellen, noted that, "Our banks have thrived since we passed Dodd-Frank. Both big banks and community banks are literally making record profits."

Now, Chair Yellen, while I don't know about the big banks and their record profits, what I do know is this: I am a Main Street America guy; I am a small business owner. Main Street America is hurting. Community financial institutions are hurting. And they both see no relief in sight.

So I would be interested to hear what Texas community bankers would say to Senator Warren's comments. I would also like to know what Senator Warren would say to the 126 banks in my home State of Texas that have closed since 2010. What would she say to the community bankers who have, since 2007, been hit with over 150 new regulations with over 100 rules still to be considered?

In fact, every time a rule is changed these same community financial institutions incur a cost. Even the simplest change can cost thousands of dollars and hundreds of man-hours to comply with.

Sure, some community financial institutions have consolidated to survive, swallowed by the larger banks. But others have not been so lucky. According to the FDIC, more than 1,200 counties in the United States, encompassing 16.3 million people, would have limited physical access to Main Street banking without a presence of a community bank. As someone who represents a large rural district in Texas, that is a large section of my constituency.

So, Chair Yellen, while I do not expect my colleague from Massachusetts to understand Main Street America's burdens, I truly hope that you do understand those, that the position of many of these community banks, financial institutions find themselves in, and that you stay true to your word in finding a way to provide meaningful relief.

Now, I want to briefly go back and touch on the Federal Reserve's balance sheet. You seem to have indicated yesterday that the Fed was in no hurry to reduce its massive $4.5 trillion balance sheet, and you said that today.

So following up on some questions from Mr. Barr, we have heard a lot of talk the last couple of days from you and others on the strength of the economy and, again, how banks are making record profits, but you also stated that the Fed wouldn't reduce the balance sheet until it has confidence the economy is on a solid course.

So I guess my question to you is, which is it? And if our economy is headed in the right direction, as you have said, why wouldn't the Fed reduce its balance sheet? So my question would be, what is stopping the Fed from naturally winding down its balance sheet, let alone offering a clear and credible strategy for doing so?

Mrs. YELLEN. I think the economy is doing well, but it has required a highly accommodative policy from the Fed to accomplish that. So our overnight Federal funds rate at 50 to 75 basis points remains quite low. If the economy were to now be hit by a negative shock—not something I expect, but we have to prepare for—we would not have a great deal of scope to support the economy by cutting that overnight rate.

My colleagues and I have said we want to wait to start running off our balance sheet until normalization is well under way. That means we would like to have a bit more buffer room to cut our overnight rate in the event that there is a negative shock because once we start running off the balance sheet it creates some drag, and we want to make sure that the economy is robust enough and we have enough policy space.

Mr. WILLIAMS. My next question is, in terms of opportunities that American households have gone without during this lackluster recovery, does the Fed's oversized and distortionary balance sheet, as well as the uncertainty that follows from the lack of a credible exit plan, create an unacceptable economic risk? And should it?

Mrs. YELLEN. What do you mean by economic risk from our balance sheet? We added to our balance sheet to push down interest rates and spur spending to ease financial conditions at a time when the economy was very weak, and it has strengthened substantially. And I think we have made a contribution to that, so I don't think

that is a significant risk. And we have indicated that we intend to contract our balance sheet substantially, but in a gradual way that is not risky.

Mr. WILLIAMS. Okay. Thank you.

I yield back.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Maine, Mr. Poliquin.

Mr. POLIQUIN. Thank you, Mr. Chairman, very much.

And thank you very much, Chair Yellen, for being here. You know, we got about 2 feet of snow, Chair Yellen, in Maine on Monday, and we have another 2 or 3 feet coming this weekend, so if you haven't made your vacation plans for the great State of Maine, this is something you ought to consider, especially since it was Valentine's Day yesterday, and I am sure your husband would love to go up there with you, and we need the business.

Mrs. YELLEN. I am sure. Thank you for the invitation.

Mr. POLIQUIN. Yes, ma'am.

Chair Yellen, across my district and across America we have been very concerned about the weakest economy we have had in decades—and the recovery, I should say. The GDP is growing at about 1.5 percent roughly instead of 3, which has been the average. Folks are living paycheck to paycheck in my district. They are having a hard time saving. Millions of folks have just given up looking for work.

And earlier in this hearing I remember, in response to a question from Mr. Huizenga, I believe what you said is that our labor participation rate has been so high because there are so many people who are aging out of the workforce. Well, let me tell you a little story if I may, Chair Yellen, with all due respect.

Mrs. YELLEN. It has been falling for that reason.

Mr. POLIQUIN. I beg your pardon.

A few months ago I was at a shoemaker in Lewiston, Quoddy Shoes, one of the greatest shoemakers still left in America, and I ran into a fellow who was working part time, at 80 years old—80 years old and he is making shoes. And he was very concerned about running out of money before he runs out of time.

Now, I happen to think, Chair Yellen, that we ought to do everything we can to grow this economy because that is just not fair and it is not right.

Now, I am sure you look at the same data we do. In December we saw that consumer confidence was at a 15-year high. Now, I know it ticked down a little bit in January, but it was at a 15-year high. Business confidence is at about a 2-year high. And so this is all good when people are buying and businesses are investing and creating jobs, and we have more opportunity for our families.

And I talk to job creators all the time. That has been my background. And I will tell you why they are so confident is because they are no longer worried about another layer of regulations and taxes falling on their shoulders that is making it hard for them to succeed and create jobs.

So can't we agree, Chair Yellen, that this overregulation that we have seen in this economy for the past 7 or 8 years has been stifling growth and opportunity?

Mrs. YELLEN. We even noted in our FOMC statement the pickup we have seen in recent months in business and consumer confidence. That is very real and—

Mr. POLIQUIN. Would you attribute that in part to overregulation or going in a different direction now? Less regulations, lower taxes, more confidence, more spending, more jobs.

Mrs. YELLEN. I think we should do everything we can to relieve regulatory burden, and I pledge to do so and to focus intensely with it to work with the new Administration.

Mr. POLIQUIN. Thank you for that.

I noticed yesterday in front of the Senate you mentioned that you were very supportive of adjusting financial regulations, especially for small community banks, and I am thrilled about that.

But you know, it is not only the financial regulations that you folks are responsible for that permeate our economy, but it is also regulations at the EPA. For example, we have a great paper mill in Skowhegan with 850 jobs, and they are worried about biomass energy being carbon neutral or not and the additional regulations that come with it.

So it is in all different sectors of the economy, Chair Yellen.

During your June 22nd testimony, when a question was asked of you by Representative Barr about the economy being underperforming, your response was, "Our growth has been disappointing. I am not sure of the reason why."

Now, can't we agree here today that part of the reason is overregulation and that you and everybody else in a position of influence in this town can support what is going on now, which is less regulation, more jobs?

Mrs. YELLEN. Productivity growth has been quite weak for the last 6 years, and even going back before the financial crisis. It seems as though there has been a step down in the pace of productivity growth. It is not only something that we have seen in the aftermath of the crisis.

So I think there may be deeper trends there that are depressing productivity growth than just regulations.

Mr. POLIQUIN. Let me shift gears a little bit in my remaining time, Chair Yellen.

We now have almost $20 trillion in debt. The interest payments on that debt with rates at a historic low are about $240 billion a year, which is about twice what we spend on veterans' benefits.

Do you think, Chair Yellen, if this town can ever get its spending act together, balance the books, and start paying down the debt, it will give us additional confidence in the business community and among our consumers, which will lead to a growing economy and more jobs?

Mrs. YELLEN. I am not sure what the bottom line would be, but we have had a looming problem of an unsustainable—

Mr. POLIQUIN. Do you think if we are able to balance our books, ma'am, and start paying down our debt, that would help our economy grow?

Mrs. YELLEN. It could.

Mr. POLIQUIN. Thank you very much.

Chairman HENSARLING. The time of the gentleman has expired.

As the Chair advised Members earlier, we plan to adjourn this hearing in approximately 30 minutes. If any Member wishes to utilize less than their 5 minutes of allotted time, I am sure other people farther down the dais would be appreciative.

The Chair now recognizes the gentlelady from Utah, Mrs. Love.

Mrs. LOVE. Thank you, Chair Yellen, and thank you for being here today. I always find myself pinching myself whenever we are in a hearing with you because of the importance of what we are doing here. And so I want you to know how sincere I am with respect to the questions and the answers that we get here. So thank you for being here.

Mrs. YELLEN. Thank you.

Mrs. LOVE. In creating the Federal Reserve in 1913, Congress charged the new central bank with the authority to set monetary policy, with the objective of ensuring price stability—that is, avoiding inflation that could undermine economic growth.

In 1978 the Humphrey Hawkins Act expanded the Fed's mandate to include goals of maximum employment, stable prices, and moderate long-term interest rates. And of course, along with its responsibilities over monetary policy, the Fed also enjoys very significant powers and responsibilities with regards to bank supervision and now also systemic stability.

This array of powers has left Congress, the markets, and the public looking to the Fed for progress and assurance on nearly every conceivable topic having to do with the Nation's financial and economic well-being. So just listening to the range of questions that you have been asked and the Humphrey Hawkins hearing shows that it is true, including questions about topics like income inequality with African-American unemployment.

This is my question to you: Do you agree with my observations in how much the Fed is doing, along with Representative Barr's observations and his testimony, to the extent in which Congress is looking to the Fed for answers and guidance?

Mrs. YELLEN. I do see that and we have, as you pointed out, a huge range of important responsibilities which we try to carry out as best we can.

It is also important for you to understand that there are limits on what we can do. We are not able to address every problem. If there is slow productivity growth in the United States, that is not something that the Fed has much ability to address.

Mrs. LOVE. Do you think—

Mrs. YELLEN. If there is income inequality, or the composition of jobs has changed in an adverse way—

Mrs. LOVE. I get it.

Okay, do you think that we are looking to the Fed for too much, in your opinion?

Mrs. YELLEN. Sometimes I do feel that, yes.

Mrs. LOVE. If so, how do you think we can pare down our expectations of the Federal Reserve?

Mrs. YELLEN. You have set forth your expectations in legislation very clearly and you described them. You said our responsibility for monetary policy is stable prices, maximum employment, and moderate long-term interest rates—

Mrs. LOVE. Do you think that there is room here to pare down or to eliminate the dual mandate that is set on—

Mrs. YELLEN. No, I don't think that would be a good idea. Those two goals of maximum employment and stable prices are rarely in conflict—

Mrs. LOVE. Okay. So we talked about a couple of things. One of the things that we have talked about was our regulation and the regulatory burdens.

Here is my problem: In April of 2011, the Fed predicted a 3.25 percent real annual growth rate. Actual real GDP growth rate for that year was 1.6 percent, according to official BEA data.

Fed forecasts for 2012 and 2013 were both close to 4 percent. Actual for 2012 was 2.2 percent; 2013 fell even further short of original predictions. I can go on and on.

Annual growth came in far less, at 1.9 percent in 2016, when it was predicted at 3 percent. So I am asking if you think—do you think that these numbers underscore the failures of unconventional policies to try and deliver expected results?

Is there too much going on? Is there a way that through both paring down the dual mandate and also paring down regulations that we can actually bring that growth rate up?

Mrs. YELLEN. Our unemployment rate forecasts prove much closer to being accurate. You have asked us to focus on maximum employment. We have, and I believe we have succeeded in meeting Congress' goal for us.

Mrs. LOVE. But we are still looking at—

Mrs. YELLEN. The fact that economic growth—

Mrs. LOVE. We—

Mrs. YELLEN. —has been so disappointing, been so low—

Mrs. LOVE. Okay. I have about 2 seconds, and I just wanted to say that we are still not happy with the rate of employment when it comes to African-Americans. We can do a lot better. We can do a lot better in our—

Mrs. YELLEN. As you just recognized, there are limits on what the Fed can accomplish—

Chairman HENSARLING. The time of the gentlelady has expired.

The Chair now recognizes the gentleman from Arkansas, Mr. Hill.

Mr. HILL. Thank you, Mr. Chairman.

Chair Yellen, it's nice to have you back before the committee. Thank you for your patience today.

One of the great compromises back in 1913 on the formation of the Federal Reserve regarded the importance and political decision to have the district banks, how they were owned, how they were spread around the country, and that—do you agree generally that they provided a good, diverse, strong voice in both supervisory and monetary policymaking over that 10 decades?

Mrs. YELLEN. With respect to monetary policy, I feel it has been very good to have the diversity, the input from around the country, and a large group of people with diverse views trying to form a consensus. That has been very healthy.

On supervisory policy, the reserve banks execute a great deal of supervision. They have responsibility, particularly for community banks. But it is the Board of Governors that is charged with set-

ting supervisory policy and putting regulations into effect, and so that policy guidance comes from the Board of Governors that is carried out in the reserve banks.

Mr. HILL. But you do believe the Board of Governors listens to the members of the boards of the district banks, even on their supervisory suggestions, don't you?

Mrs. YELLEN. I'm sorry, the members of the Board or—

Mr. HILL. The members of the Board of Governors in Washington, they do listen to the views of the district bank board members as it relates to supervisory policy, do they not?

Mrs. YELLEN. The directors of the reserve banks don't weigh in on bank supervision and—

Mr. HILL. Should they?

Mrs. YELLEN. —that supervision policy.

Mr. HILL. Should they have that added to their list of suggestions? You have—

Mrs. YELLEN. No. I think that the directors, especially given the role of banks on the boards and the fact that there are bank directors, it has been important to wall them off from—

Mr. HILL. There are a lot of district bank directors that are not bank directors. They are citizens, just from various industries.

Mrs. YELLEN. Yes.

Mr. HILL. Do you think that the supervisors in the district banks have a good handle on their banks, their bankers, their bank asset quality, their bank supervision within the confines of their district?

Mrs. YELLEN. Yes.

Mr. HILL. So wouldn't it be a good idea to try to have merger and acquisition applications and expansion-type applications and business combination applications all handled at the district bank level?

Mrs. YELLEN. The Board has responsibility ultimately for those decisions, and much of the work on them is done at the reserve banks. But in some cases, the Board has legal authority to make decisions.

Mr. HILL. Do you think it is a decent policy to defer to the local reserve bank as a general statement and only in special instances have decisions come to the Board of Governors level for approval?

Mrs. YELLEN. I think in many cases decisions are routine, and the recommendations to the Board come from the reserve banks. I wouldn't favor changing the governance structure around that.

Mr. HILL. Thank you.

On the subject of Mr. Williams' questions about the size of the Federal Reserve balance sheet, obviously during the crisis you owned a lot of nontraditional assets as a function of getting through the crisis period.

And you have, through the payment of reserves, built a large portfolio of government securities. It looks like you have 40 percent of the mortgage-backed—your portfolio is 40 percent in mortgage-backed securities; you have 20 percent of the balance sheet with a maturity greater than 5 years in Treasuries; and that you, at last count I saw, owned 15 percent of the world's total supply of U.S. Treasuries.

Do those numbers sound generally right?

Mrs. YELLEN. I don't have them in front of me, but they sound generally right.

Mr. HILL. When banks have to go through a bank examination, there is a section of the CAMELS rating that has an S for interest rate sensitivity. And it would seem to me that you have a very substantial concentration of risk in that balance sheet and the size that it is and a significant sensitivity to risk because you have extended duration.

When I was looking at the numbers I was reminded of two of my favorite quotes. One was old—Mr. Oakley Hunter, who used to be the CEO of Fannie Mae back in the late 1970s, described his own company when he was president as the world's largest crap game. And then Mr. Buffett in 2008 described the Federal Reserve as history's greatest hedge fund.

And so my concern is that through Operation Twist, as you try to undo the portfolio, that you have a real interest rate sensitivity problem. I hope you will address that and move quickly to reduce the size of the Fed's balance sheet.

Thank you, Mr. Chairman.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Texas, Mr. Gonzalez.

Mr. GONZALEZ. Thank you.

I have a couple of questions.

Chair Yellen, President Trump has stated he intends to create 25 million new jobs. However, given Trump's anti-immigrant stance, where would the President get 25 million people to fill these jobs?

Mrs. YELLEN. Immigration has been a very important source of labor force growth. I would estimate that with the economy having a 4.8 percent unemployment rate, looking forward job growth mainly has to come from additions to the labor force. There might be some increase in labor force participation, but we would need labor force growth.

Given our projections on labor force growth, something like 75,000 to 125,000 jobs a month would be consistent with a stable unemployment rate. And so if immigration were to reduce labor force growth, the pace of job growth consistent with our staying with roughly 4.8 percent unemployment would move down, not up.

Mr. GONZALEZ. Right. What role does immigration into the United States have on the growth and competitiveness of our economy?

Mrs. YELLEN. That is a broad question I am not sure that I can answer, but it has been an important support for labor force growth, and it has been important in many sectors.

Mr. GONZALEZ. Thank you for your response.

Chairman HENSARLING. The gentleman yield back.

The Chair now recognizes the gentleman from Michigan, Mr. Trott.

Mr. TROTT. Thank you, Mr. Chairman.

And, Chair Yellen, thank you for your time today and for your service.

I want to follow up on a question that Mr. Lynch was asking earlier regarding the OLA under Title II of Dodd-Frank. And I think you said that you preferred a bankruptcy alternative but wanted

to maintain the OLA just in case there was a scenario that couldn't be anticipated.

I think you also said, though, that under OLA, the taxpayers wouldn't be put at risk. Did I misunderstand, or do you stand by that statement?

Mrs. YELLEN. Yes. The way it is set up is that if the FDIC realized any losses they would be passed onto the banking industry, which would chip in to compensate.

Mr. TROTT. So if the FDIC borrows trillions of dollars to compensate creditors it is not going to put taxpayers at risk?

Mrs. YELLEN. I'm sorry, if the what?

Mr. TROTT. If the FDIC borrows trillions of dollars to compensate creditors, the bank, it is not putting taxpayers at risk?

Mrs. YELLEN. I think there is a limit on what they can borrow and it wouldn't be trillions of dollars.

Mr. TROTT. But taxpayers would be at risk under that scenario if they were borrowing, wouldn't they?

Mrs. YELLEN. It is structured so that the costs would be borne by the financial sector.

Mr. TROTT. Okay.

In December I was back home and I went to a holiday party at the Bank of Birmingham, which is a community bank in Birmingham, Michigan. And the CEO pulled me in his office and he said, "I just want to let you know we are selling. We can't continue." And they have since sold to the Bank of Ann Arbor.

So I would like to know what you are doing today and what we can do to help save our community banks. Because I really see it as an obstacle to growth in our economy, and I really believe it is one of the reasons why no one is starting small businesses and young people under 30 aren't owning businesses. The lack of credit for small business is a big issue, and I would like to hear your thoughts on that.

Mrs. YELLEN. So small businesses don't by and large report in surveys when they are asked that lack of access to loans or credit is one of the significant problems that they face, and we have seen pretty solid growth of credit overall from the banking sector, including small business loans.

Banks are under a great deal of pressure for a number of different reasons. We have a low interest rate environment. Their net interest margins have been compressed and that tends to reduce profitability.

Still, I believe community banks in the United States last year made profits of something like $5.5 billion. But there are banks that are under pressure and, of course, consolidation is a trend.

For our part, I have emphasized repeatedly today that regulatory burdens on community banks need to be reduced. I would be very pleased to see Congress take steps in that direction, and we will also do all that we can to cooperate in reducing those burdens.

Mr. TROTT. Great.

I want to save some time for my colleagues, so my last question is, we have heard a lot of nice speeches from my friends on the other side of the aisle today about all the problems that President Trump has created in the last 25 days. Why is the stock market doing so well? Why do we have a record high in the stock market?

Mrs. YELLEN. I think market participants likely are anticipating shifts in fiscal policy that will stimulate growth, perhaps raise earnings, maybe tax cuts that will boost earnings. We have seen longer-term interest rates go up and the dollar strengthen, and that is consistent with expectations of an expansionary fiscal policy.

Mr. TROTT. Would it be fair to say then, the prospect of easing the regulatory burden created by Dodd-Frank is causing investors and businesses to feel more optimistic about our economy?

Mrs. YELLEN. I have no idea what portion Dodd-Frank plays in that. I have no way of knowing that.

Mr. TROTT. Thank you, Chair Yellen.

I yield back.

Chairman HENSARLING. The gentleman yields back.

The Chair now recognizes the gentleman from Georgia, Mr. Loudermilk.

Mr. LOUDERMILK. Thank you, Mr. Chairman.

Chair Yellen, as many have discussed here today, the Fed currently holds about $1.7 trillion worth of mortgage-backed securities, which, surprisingly, equates to about 21 percent of all the mortgage-backed securities. This has been unprecedented because in the decades before the recession, the Fed had virtually zero mortgage-backed securities on its book.

But yesterday at the Senate Banking Committee hearing when this issue was brought up, why such a large number of mortgage-backed securities are currently on the books of the Fed, you stated that, "After the financial crisis, at a time when the economy was very depressed, unemployment was very high, inflation was running below the Fed's objectives and extraordinary support was needed."

And that is how you explained why you purchased so many mortgage-backed securities when prior to that, you had none.

Mrs. YELLEN. Treasury securities.

Mr. LOUDERMILK. Right.

Mrs. YELLEN. Both.

Mr. LOUDERMILK. However, today, we have heard from you and some others in here about how well we are doing now. The economy is going well, unemployment is going down.

If the reason that you bought those, and you said that you are going to divest yourself of those via attrition over time, but my question is just last week the Fed purchased $8.5 billion of mortgage-backed securities.

Mrs. YELLEN. All we do is reinvest proceeds of maturing principal to keep the size of our balance sheet unchanged. We are not doing any net purchases of either Treasuries or mortgage-backed securities.

Mr. LOUDERMILK. But is this in any way divesting yourself?

Mrs. YELLEN. We have not started the process of divesting ourselves. We are maintaining at a constant level the size of our portfolio and leaving the composition unchanged for now. But we anticipate at some point beginning the process you described of allowing maturing principal—we will stop reinvesting it and our balance sheet will gradually shrink.

Mr. LOUDERMILK. So what you are telling me is the Reuters report that came out on Thursday which reported that you bought $8.5 billion worth of mortgage-backed securities isn't exactly accurate?

Mrs. YELLEN. If we had, I don't know the details, but to the extent we have principal repayments on mortgage-backed securities, we would take those principal repayments and reinvest in mortgage-backed securities to keep our holdings at a constant level.

So that is our reinvestment. We are reinvesting maturing principal and it might have amounted to the number that you cited. I don't know for sure.

Mr. LOUDERMILK. $8.5 billion, that is a pretty significant number, especially holding 21 percent of all mortgage-backed securities.

Mrs. YELLEN. We are not—

Mr. LOUDERMILK. Does that not put you and the taxpayers at a significant risk?

Mrs. YELLEN. We are not adding to our holdings of mortgage-backed securities. We are maintaining our holdings unchanged in dollar terms. And these are securities that have essentially no credit risk. And of course, there is interest rate risk in our portfolio—

Mr. LOUDERMILK. And can you remind me, what was the significant factor in causing the crash in 2008? Wasn't it the same idea that these have very little credit risk, but yet, that was the impetus with what brought us into the recession?

Mrs. YELLEN. These are government-guaranteed mortgages. And we are entitled, again, in the terms of our charter to invest in Treasury and agency debt, and these are agencies—

Mr. LOUDERMILK. In your opinion, then, this doesn't put the American taxpayer at risk or the Fed at significant risk by holding 21 percent of mortgage-backed securities, and you are not divesting at this time?

Mrs. YELLEN. I don't see that there is significant risk. A central bank operates in a very different way than a normal commercial bank. Our ability to conduct monetary policy, which is our prime responsibility, doesn't depend on if they reflect—the value of those securities may fluctuate, but that has no impact on our ability to conduct monetary policy.

We could have unrealized losses in those portfolios, but we have no intention and we have stated for a long time that we do not intend to sell mortgage-backed securities, so we would not realize those losses.

Our holdings of them have swelled since the financial crisis. The payments that we are making to the Treasury that positively impact the Federal budget—prior to the crisis our payments to the Treasury ran around $20 billion to $25 billion, and last year they came close to $100 billion. And—

Chairman HENSARLING. Time—

Mrs. YELLEN. —we have supported growth in the economy.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair wishes to advise Members that currently, I intend to recognize the gentleman from Ohio, Mr. Davidson, and the gentleman from North Carolina, Mr. Budd, and we will adjourn at that time.

The gentleman from Ohio, Mr. Davidson, is recognized.

Mr. DAVIDSON. Thank you, Mr. Chairman.

And thank you, Chair Yellen. It is an honor to speak with you, and thanks for taking a big chunk of time to talk with us today.

What we have raised on the screen here is a trade-weighted U.S. dollar index. And for an extended period of time, your time as Chair of the Fed, you have emphasized a desire to raise rates. To what extent has currency appreciation impacted your ability to do that?

Mrs. YELLEN. I think the appreciation of the dollar partly reflects market expectations that we would be raising rates faster than many other advanced countries. Our economy has been growing more strongly and we have had stronger economic performance.

The expectation that rates would diverge with the United States moving to higher rates than other counties has induced capital inflows, which have served to push up the dollar, as your chart influences shows. And that is one of the ways in which monetary policy normally works.

Mr. DAVIDSON. Right.

Mrs. YELLEN. Of course, it has tended to diminish net exports. It has had a negative effect on our exports. It has diminished spending in the economy, and it is part of how a tighter monetary policy or perceptions that there will be works to slow aggregate demand.

Mr. DAVIDSON. Right. And so in that sense, it is holding down the same pressures that you would hope to do, so the strong dollar is doing some of the same things you would hope to do with the rate appreciation.

Mrs. YELLEN. That is right.

Mr. DAVIDSON. But the effect for the saver, then, with the currency appreciating, is that rates are still low, so time, value, and money, the rates are still held low, and it has an impact on hard-working families trying to save for retirement. While it might have a similar effect for monetary policy, the effect on Americans in the domestic economy. Would you agree with that?

Mrs. YELLEN. Yes, how the dollar moves is a factor. As I say, it is part of a response to monetary policy, but it is not mechanical and that does affect the interest rate path we put in place that is appropriate.

Mr. DAVIDSON. Thank you for that.

Now, one of the things that you had talked about as—you were commenting on policy so I won't ask you a specific policy question, but in theory, if there were an adjustment that had an effect of raising the cost of imports by, say, 20 percent, and there was something that had the effect of lowering the cost of exports, would the currency market fully clear? Do you believe that would happen? And if so, would that still resolve in a net change in our balance of trade?

Mrs. YELLEN. I would note that there have been discussions and academic work in connection with the border tax that suggests that an appreciation of the dollar could fully offset, as you have said, a tax change that raised the cost of imports and provided a comparable export subsidy. And in principle that could provide a full offset.

The problem is there is great uncertainty about how, in reality, markets would really respond to these changes, and a strong set of assumptions is needed to believe that markets would fully offset those changes.

It is very difficult to know just what would happen. There is more than trade that affects a country's exchange rates.

Market participants' expectations matter and there is a great deal of wealth. There would be shifts in wealth. The value of U.S. assets held in foreign currencies would be greatly diminished by that—

Mr. DAVIDSON. Thanks. I think you anticipate my next question, which is $2-plus trillion of U.S. assets held offshore, one of the desires would be to see some of that put to work in the U.S. economy.

To what extent over the past several years of high appreciation of the U.S. dollar does that affect the value of the repatriation, and do you feel that currency would have an impact in the present context of relatively high rates in anything we would do policy-wise with fiscal policy to drive those balance of payments?

Mrs. YELLEN. That was a complicated question and I am not sure I have—

Mr. DAVIDSON. Sorry. And you have been answering them for a long time, so the net effect of the currency appreciation on repatriation. Is there a fiscal policy that we would do that you feel that would be offset by the strong dollar? What would happen in that context?

Mrs. YELLEN. I am not sure I have a simple answer for you to that complicated question.

Mr. DAVIDSON. My time has expired.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from North Carolina, Mr. Budd.

Mr. BUDD. Thank you, Chair Yellen, for joining us today.

I will shorten the question. Something has changed in our economy since 2009, and I want to know if you think that in the last 8 years, the expansionary monetary policy or the financial regulations have played a role in the growing populations of both the poor and the very wealthy by hurting middle-class savers?

Mrs. YELLEN. Are you referring to the fact that we have had low interest rates and it has hurt middle-class savers?

Mr. BUDD. I would say that combined with the financial regulations and how it has had an effect on those middle-class savers, if you see a correlation there.

Mrs. YELLEN. I am not sure I see how—I think financial regulation has resulted in a stronger financial system and less risk substantially than we have had before the crisis. I think it has enabled us to have stronger growth and a faster recovery than some other advanced nations, including European nations. And in that sense, I think it has been beneficial.

But, of course, savers have been impacted by the low interest rate environments, and I hear from them every day, as I am sure you do. They would welcome higher interest rates, and if the economy continues to move along a solid path, it is my hope that we will be able to raise interest rates more rapidly and they will see

some of that pass through to their savings earn higher returns on them.

Mr. BUDD. Thank you. So the next part of that—so when I do talk to the community banks in my district they keep telling me that the fastest-growing department in their business, in their bank, is the compliance department. So this seems to be borne out of the fact that we are now near zero as far as it comes to new bank charters, where it used to be hundreds of new bank charters a year.

Do you think the fact that banks have had to massively increase their spending on regulatory compliance is helpful or harmful to banks' abilities to make loans for individuals and small businesses?

Mrs. YELLEN. I agree with everyone this morning who has expressed concern about regulatory burdens on community banks, and I pledge to do everything in our power to attempt to look for ways to mitigate those burdens.

Mr. BUDD. Thank you.

I yield back my time.

Chairman HENSARLING. The gentleman yields back.

I would like to thank Chair Yellen for her testimony today.

The Chair notes that some Members may have additional questions for this witness, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to this witness and to place her responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

I would ask, Chair Yellen, that you please respond as promptly as you are able.

This hearing stands adjourned.

[Whereupon, at 2:11 p.m., the hearing was adjourned.]

A P P E N D I X

February 15, 2017

Statement by

Janet L. Yellen

Chair

Board of Governors of the Federal Reserve System

before the

Committee on Financial Services

U.S. House of Representatives

February 15, 2017

Chairman Hensarling, Ranking Member Waters, and other members of the Committee, I am pleased to present the Federal Reserve's semiannual *Monetary Policy Report* to the Congress. In my remarks today I will briefly discuss the current economic situation and outlook before turning to monetary policy.

Current Economic Situation and Outlook

Since my appearance before this Committee last June, the economy has continued to make progress toward our dual-mandate objectives of maximum employment and price stability. In the labor market, job gains averaged 190,000 per month over the second half of 2016, and the number of jobs rose an additional 227,000 in January. Those gains bring the total increase in employment since its trough in early 2010 to nearly 16 million. In addition, the unemployment rate, which stood at 4.8 percent in January, is more than 5 percentage points lower than where it stood at its peak in 2010 and is now in line with the median of the Federal Open Market Committee (FOMC) participants' estimates of its longer-run normal level. A broader measure of labor underutilization, which includes those marginally attached to the labor force and people who are working part time but would like a full-time job, has also continued to improve over the past year. In addition, the pace of wage growth has picked up relative to its pace of a few years ago, a further indication that the job market is tightening. Importantly, improvements in the labor market in recent years have been widespread, with large declines in the unemployment rates for all major demographic groups, including African Americans and Hispanics. Even so, it is discouraging that jobless rates for those minorities remain significantly higher than the rate for the nation overall.

Ongoing gains in the labor market have been accompanied by a further moderate expansion in economic activity. U.S. real gross domestic product is estimated to have risen

1.9 percent last year, the same as in 2015. Consumer spending has continued to rise at a healthy pace, supported by steady income gains, increases in the value of households' financial assets and homes, favorable levels of consumer sentiment, and low interest rates. Last year's sales of automobiles and light trucks were the highest annual total on record. In contrast, business investment was relatively soft for much of last year, though it posted some larger gains toward the end of the year in part reflecting an apparent end to the sharp declines in spending on drilling and mining structures; moreover, business sentiment has noticeably improved in the past few months. In addition, weak foreign growth and the appreciation of the dollar over the past two years have restrained manufacturing output. Meanwhile, housing construction has continued to trend up at only a modest pace in recent quarters. And, while the lean stock of homes for sale and ongoing labor market gains should provide some support to housing construction going forward, the recent increases in mortgage rates may impart some restraint.

Inflation moved up over the past year, mainly because of the diminishing effects of the earlier declines in energy prices and import prices. Total consumer prices as measured by the personal consumption expenditures (PCE) index rose 1.6 percent in the 12 months ending in December, still below the FOMC's 2 percent objective but up 1 percentage point from its pace in 2015. Core PCE inflation, which excludes the volatile energy and food prices, moved up to about 1-3/4 percent.

My colleagues on the FOMC and I expect the economy to continue to expand at a moderate pace, with the job market strengthening somewhat further and inflation gradually rising to 2 percent. This judgment reflects our view that U.S. monetary policy remains accommodative, and that the pace of global economic activity should pick up over time, supported by accommodative monetary policies abroad. Of course, our inflation outlook also

depends importantly on our assessment that longer-run inflation expectations will remain reasonably well anchored. It is reassuring that while market-based measures of inflation compensation remain low, they have risen from the very low levels they reached during the latter part of 2015 and first half of 2016. Meanwhile, most survey measures of longer-term inflation expectations have changed little, on balance, in recent months.

As always, considerable uncertainty attends the economic outlook. Among the sources of uncertainty are possible changes in U.S. fiscal and other policies, the future path of productivity growth, and developments abroad.

Monetary Policy

Turning to monetary policy, the FOMC is committed to promoting maximum employment and price stability, as mandated by the Congress. Against the backdrop of headwinds weighing on the economy over the past year, including financial market stresses that emanated from developments abroad, the Committee maintained an unchanged target range for the federal funds rate for most of the year in order to support improvement in the labor market and an increase in inflation toward 2 percent. At its December meeting, the Committee raised the target range for the federal funds rate by 1/4 percentage point, to 1/2 to 3/4 percent. In doing so, the Committee recognized the considerable progress the economy had made toward the FOMC's dual objectives. The Committee judged that even after this increase in the federal funds rate target, monetary policy remains accommodative, thereby supporting some further strengthening in labor market conditions and a return to 2 percent inflation.

At its meeting that concluded early this month, the Committee left the target range for the federal funds rate unchanged but reiterated that it expects the evolution of the economy to warrant further gradual increases in the federal funds rate to achieve and maintain its

employment and inflation objectives. As I noted on previous occasions, waiting too long to remove accommodation would be unwise, potentially requiring the FOMC to eventually raise rates rapidly, which could risk disrupting financial markets and pushing the economy into recession. Incoming data suggest that labor market conditions continue to strengthen and inflation is moving up to 2 percent, consistent with the Committee's expectations. At our upcoming meetings, the Committee will evaluate whether employment and inflation are continuing to evolve in line with these expectations, in which case a further adjustment of the federal funds rate would likely be appropriate.

The Committee's view that gradual increases in the federal funds rate will likely be appropriate reflects the expectation that the neutral federal funds rate--that is, the interest rate that is neither expansionary nor contractionary and that keeps the economy operating on an even keel--will rise somewhat over time. Current estimates of the neutral rate are well below pre-crisis levels--a phenomenon that may reflect slow productivity growth, subdued economic growth abroad, strong demand for safe longer-term assets, and other factors. The Committee anticipates that the depressing effect of these factors will diminish somewhat over time, raising the neutral funds rate, albeit to levels that are still low by historical standards.

That said, the economic outlook is uncertain, and monetary policy is not on a preset course. FOMC participants will adjust their assessments of the appropriate path for the federal funds rate in response to changes to the economic outlook and associated risks as informed by incoming data. Also, changes in fiscal policy or other economic policies could potentially affect the economic outlook. Of course, it is too early to know what policy changes will be put in place or how their economic effects will unfold. While it is not my intention to opine on specific tax or spending proposals, I would point to the importance of improving the pace of longer-run

economic growth and raising American living standards with policies aimed at improving productivity. I would also hope that fiscal policy changes will be consistent with putting U.S. fiscal accounts on a sustainable trajectory. In any event, it is important to remember that fiscal policy is only one of the many factors that can influence the economic outlook and the appropriate course of monetary policy. Overall, the FOMC's monetary policy decisions will be directed to the attainment of its congressionally mandated objectives of maximum employment and price stability.

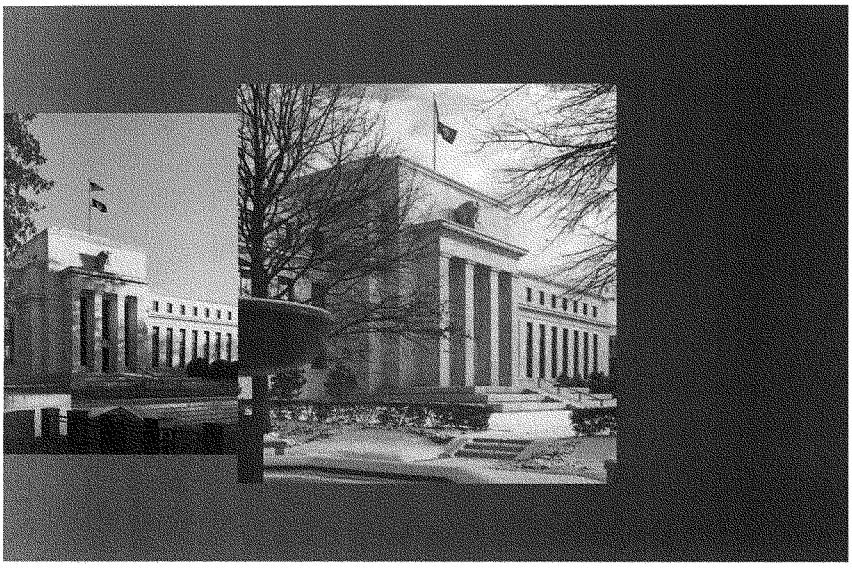
Finally, the Committee has continued its policy of reinvesting proceeds from maturing Treasury securities and principal payments from agency debt and mortgage-backed securities. This policy, by keeping the Committee's holdings of longer-term securities at sizable levels, has helped maintain accommodative financial conditions.

Thank you. I would be pleased to take your questions.

For use at 10:00 a.m., EST
February 14, 2017

Monetary Policy Report

February 14, 2017



Board of Governors of the Federal Reserve System

Letter of Transmittal

Board of Governors of the
Federal Reserve System

Washington, D.C., February 14, 2017

The President of the Senate
The Speaker of the House of Representatives

The Board of Governors is pleased to submit its *Monetary Policy Report* pursuant to section 2B of the Federal Reserve Act.

Sincerely,

Janet L. Yellen

Janet L. Yellen, Chair

Statement on Longer-Run Goals and Monetary Policy Strategy

Adopted effective January 24, 2012; as amended effective January 31, 2017

The Federal Open Market Committee (FOMC) is firmly committed to fulfilling its statutory mandate from the Congress of promoting maximum employment, stable prices, and moderate long-term interest rates. The Committee seeks to explain its monetary policy decisions to the public as clearly as possible. Such clarity facilitates well-informed decisionmaking by households and businesses, reduces economic and financial uncertainty, increases the effectiveness of monetary policy, and enhances transparency and accountability, which are essential in a democratic society.

Inflation, employment, and long-term interest rates fluctuate over time in response to economic and financial disturbances. Moreover, monetary policy actions tend to influence economic activity and prices with a lag. Therefore, the Committee's policy decisions reflect its longer-run goals, its medium-term outlook, and its assessments of the balance of risks, including risks to the financial system that could impede the attainment of the Committee's goals.

The inflation rate over the longer run is primarily determined by monetary policy, and hence the Committee has the ability to specify a longer-run goal for inflation. The Committee reaffirms its judgment that inflation at the rate of 2 percent, as measured by the annual change in the price index for personal consumption expenditures, is most consistent over the longer run with the Federal Reserve's statutory mandate. The Committee would be concerned if inflation were running persistently above or below this objective. Communicating this symmetric inflation goal clearly to the public helps keep longer-term inflation expectations firmly anchored, thereby fostering price stability and moderate long-term interest rates and enhancing the Committee's ability to promote maximum employment in the face of significant economic disturbances. The maximum level of employment is largely determined by nonmonetary factors that affect the structure and dynamics of the labor market. These factors may change over time and may not be directly measurable. Consequently, it would not be appropriate to specify a fixed goal for employment; rather, the Committee's policy decisions must be informed by assessments of the maximum level of employment, recognizing that such assessments are necessarily uncertain and subject to revision. The Committee considers a wide range of indicators in making these assessments. Information about Committee participants' estimates of the longer-run normal rates of output growth and unemployment is published four times per year in the FOMC's Summary of Economic Projections. For example, in the most recent projections, the median of FOMC participants' estimates of the longer-run normal rate of unemployment was 4.8 percent.

In setting monetary policy, the Committee seeks to mitigate deviations of inflation from its longer-run goal and deviations of employment from the Committee's assessments of its maximum level. These objectives are generally complementary. However, under circumstances in which the Committee judges that the objectives are not complementary, it follows a balanced approach in promoting them, taking into account the magnitude of the deviations and the potentially different time horizons over which employment and inflation are projected to return to levels judged consistent with its mandate.

The Committee intends to reaffirm these principles and to make adjustments as appropriate at its annual organizational meeting each January.

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NOTE: Unless stated otherwise, the time series in the figures extend through, for daily data, February 9, 2017; for monthly data, January 2017; and, for quarterly data, 2016:Q4. In bar charts, except as noted, the change for a given period is measured to its final quarter from the final quarter of the preceding period.

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Summary

Labor market conditions continued to strengthen over the second half of 2016. Payroll employment has continued to post solid gains, averaging 200,000 per month since last June, a touch higher than the pace in the first half of 2016, though down modestly from its 225,000-per-month pace in 2015. The unemployment rate has declined slightly since mid-2016; the 4.8 percent reading in January of this year was in line with the median of Federal Open Market Committee (FOMC) participants' estimates of its longer-run normal level. The labor force participation rate has edged higher, on net, since midyear despite a structural trend that is moving down as a result of changing demographics of the population. In addition, wage growth seems to have picked up somewhat relative to its pace of a few years ago.

Consumer price inflation moved higher last year but remained below the FOMC's longer-run objective of 2 percent. The price index for personal consumption expenditures (PCE) increased 1.6 percent over the 12 months ending in December, 1 percentage point more than in 2015, importantly reflecting that energy prices have turned back up and declines in non-oil import prices have waned. The PCE price index excluding food and energy items, which provides a better indication than the headline index of where overall inflation will be in the future, rose 1.7 percent over the 12 months ending in December, about ¼ percentage point more than its increase in 2015. Meanwhile, survey-based measures of longer-run inflation expectations have remained generally stable, though some are at relatively low levels; market-based measures of inflation compensation have moved up in recent months but also are at low levels.

Real gross domestic product is estimated to have increased at an annual rate of 2¾ percent in the second half of the year after rising only 1 percent in the first half. Consumer spending has been expanding at a moderate pace, supported by solid income gains and the ongoing effects of increases in wealth. The housing market has continued its gradual recovery, and fiscal policy at all levels of government has provided a modest boost to economic activity. Business investment had been weak for much of 2016 but posted larger gains toward the end of the year. Notwithstanding a transitory surge of exports in the third quarter, the underlying pace of exports has remained weak, a reflection of the appreciation of the dollar in recent years and the subdued pace of foreign economic growth.

Domestic financial conditions have generally been supportive of economic growth since mid-2016 and remain so despite increases in interest rates in recent months. Long-term Treasury yields and mortgage rates moved up from their low levels earlier last year but are still quite low by historical standards. Broad measures of stock prices rose, and the financial sector outperformed the broader equity market. Spreads of yields of both speculative- and investment-grade corporate bonds over yields of comparable-maturity Treasury securities declined from levels that were somewhat elevated relative to the past several years. Even with an ongoing easing in mortgage credit standards, mortgage credit is still relatively difficult to access for borrowers with low credit scores, undocumented income, or high debt-to-income ratios. Student and auto loans are broadly available, including to borrowers with nonprime credit scores, and the availability of credit card loans for such borrowers appears to have expanded somewhat over the past several quarters. In foreign financial markets, meanwhile, equities, bond yields, and the exchange value of the U.S. dollar have all risen, and risk spreads have generally declined since June.

Financial vulnerabilities in the U.S. financial system overall have continued to be moderate

since mid-2016. U.S. banks are well capitalized and have sizable liquidity buffers. Funding markets functioned smoothly as money market mutual fund reforms took effect in October. The ratio of household debt to income has changed little in recent quarters and is still far below the peak level it reached about a decade ago. Nonfinancial corporate business leverage has remained elevated by historical standards even though outstanding riskier corporate debt declined slightly last year. In addition, valuation pressures in some asset classes increased, particularly late last year. The Federal Reserve has continued to take steps to strengthen the financial system, including finalizing a rule that imposes total loss-absorbing capacity and long-term debt requirements on the largest internationally active bank holding companies as well as concluding an extensive review of its stress-testing and capital planning programs.

In December, the FOMC raised the target for the federal funds rate to a range of ½ to ¾ percent after maintaining it at ¼ to ½ percent for a year. The decision to increase the federal funds rate reflected realized and expected labor market conditions and inflation. With the stance of monetary policy remaining accommodative, the Committee has anticipated some further strengthening in labor market conditions and a return of inflation to the Committee's 2 percent objective.

The Committee has continued to emphasize that, in determining the timing and size of future adjustments to the target range for the federal funds rate, it will assess realized and expected economic conditions relative to its objectives of maximum employment and 2 percent inflation. The Committee has expected that economic conditions will evolve in a manner that will warrant only gradual increases in the federal funds rate, and that the federal funds rate will likely remain, for some time, below levels that are expected to prevail in the longer run. Consistent with this outlook, in the most recent Summary of Economic Projections (SEP), which was compiled at the time of the December meeting of the FOMC, most participants projected that the appropriate level of the federal funds rate would be below its longer-run level through 2018. (The December SEP is included as Part 3 of this report.)

With respect to its securities holdings, the Committee has stated that it will continue to reinvest principal payments from its securities portfolio, and that it expects to maintain this policy until normalization of the level of the federal funds rate is well under way. This policy of keeping the Committee's holdings of longer-term securities at sizable levels should help sustain accommodative financial conditions.

Part 1
Recent Economic and Financial Developments

Labor market conditions continued to improve during the second half of last year and early this year. Payroll employment has increased 200,000 per month, on average, since June, and the unemployment rate has declined slightly further, reaching 4.8 percent in January, in line with the median of Federal Open Market Committee (FOMC) participants' estimates of its longer-run normal level. The labor force participation rate has edged higher, on net, which is all the more notable given a demographically induced downward trend.

The 12-month change in the price index for overall personal consumption expenditures (PCE) was 1.6 percent in December—still below the Committee's 2 percent objective but up noticeably from 2015, when the increase in top-line prices was held down by declines in energy prices. The 12-month change in the index excluding food and energy prices (the core PCE price index) was 1.7 percent last year. Measures of longer-term inflation expectations have been generally stable, though some survey-based measures remain lower than a few years ago; market-based measures of inflation compensation moved higher in recent months but also remain below their levels from a few years ago.

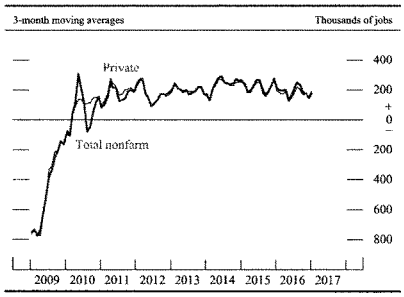
Real gross domestic product (GDP) is estimated to have increased at an annual rate of 2¾ percent over the second half of 2016 after increasing just 1 percent in the first half. The economic expansion continues to be supported by accommodative financial conditions—including the still-low cost of borrowing for many households and businesses—and gains in household net wealth, which has been boosted further by a rise in the stock market in recent months and by increases in households' real income spurred by continuing job gains. However, net exports were a moderate drag on GDP growth in the second half, as imports picked up and the rise in the exchange value of the dollar in recent years remained a drag on export demand.

Domestic Developments

The labor market has continued to tighten gradually . . .

Labor market conditions strengthened over the second half of 2016 and early this year. Payroll employment has continued to post solid gains, averaging 200,000 per month since last June (figure 1). This rate of job gains is a bit higher than that seen during the first half of 2016, though it is a little slower than the 225,000 monthly pace in 2015. The unemployment rate has declined slightly further, on net, since the middle of last year. After dipping as low as 4.6 percent in November, the unemployment rate stood at 4.8 percent in January, in line with the median of FOMC participants' estimates of its longer-run normal level.

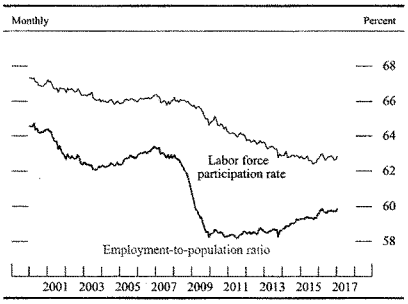
1. Net change in payroll employment



Source: Department of Labor, Bureau of Labor Statistics.

The labor force participation rate, at 62.9 percent, is up slightly since June 2016. Changing demographics and other longer-run structural changes in the labor market likely

2. Labor force participation rate and employment-to-population ratio



NOTE: Both series are a percentage of the population aged 16 and over.
SOURCE: Department of Labor, Bureau of Labor Statistics.

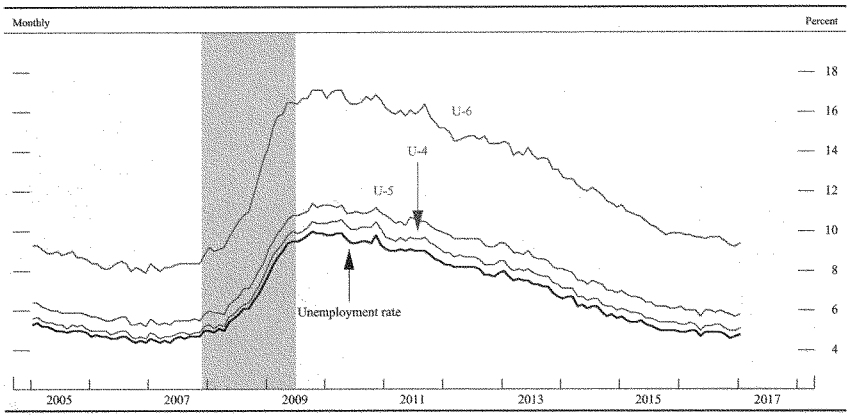
have continued to put downward pressure on the participation rate. A flat or increasing trajectory of the participation rate should therefore be viewed as a cyclical improvement relative to that downward trend. Reflecting the slightly higher participation rate and the small drop in the unemployment rate, the employment-to-population ratio has moved up about ¼ percentage point since mid-2016 (figure 2). (For additional historical context on the economic recovery, see the box "The Recovery from the Great Recession and Remaining Challenges.")

. . . and is close to full employment

Other indicators are also consistent with a healthy labor market. Layoffs as a share of private employment, as measured in the Job Openings and Labor Turnover Survey (JOLTS), remained at a low level through December, and recent readings on initial claims for unemployment insurance, a more timely measure, point to a very low pace of involuntary separations. The JOLTS quits rate has generally continued to trend up and is now close to pre-crisis levels, indicating that workers feel increasingly confident about their employment opportunities. In addition, the rate of job openings as a share of private employment has remained near record-high levels. The share of workers who are employed part time but would like to work full time—which is part of the U-6 measure of underutilization from the Bureau of Labor Statistics (BLS)—is still somewhat elevated, however, even though it has declined further; as a result, the gap between U-6 and the headline unemployment rate is somewhat wider than it was in the years before the Great Recession (figure 3).

The jobless rate for African Americans also continued to edge lower in the second half of 2016, while the rate for Hispanics remained flat; as with the overall unemployment rate, these rates are near levels seen leading into the recession. Despite these gains, the average unemployment rates for these groups of Americans have remained high relative to the aggregate, and those gaps have not narrowed over the past decade (figure 4).

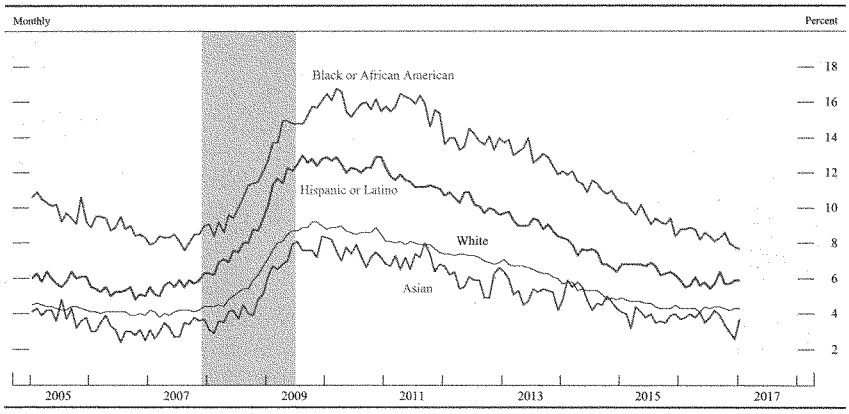
3. Measures of labor underutilization



NOTE: Unemployment rate measures total unemployed as a percentage of the labor force. U-4 measures total unemployed plus discouraged workers, as a percentage of the labor force plus discouraged workers. Discouraged workers are a subset of marginally attached workers who are not currently looking for work because they believe no jobs are available for them. U-5 measures total unemployed plus all marginally attached to the labor force, as a percentage of the labor force plus persons marginally attached to the labor force. Marginally attached workers are not in the labor force, want and areavailable for work, and have looked for a job in the past 12 months. U-6 measures total unemployed plus all marginally attached workers plus total employed part time for economic reasons, as a percentage of the labor force plus all marginally attached workers. The shaded bar indicates a period of business recession as defined by the National Bureau of Economic Research.

SOURCE: Department of Labor, Bureau of Labor Statistics.

4. Unemployment rate by race and ethnicity



NOTE: Unemployment rate measures total unemployed as a percentage of the labor force. Persons whose ethnicity is identified as Hispanic or Latino may be of any race. The shaded bar indicates a period of business recession as defined by the National Bureau of Economic Research.

SOURCE: Department of Labor, Bureau of Labor Statistics.

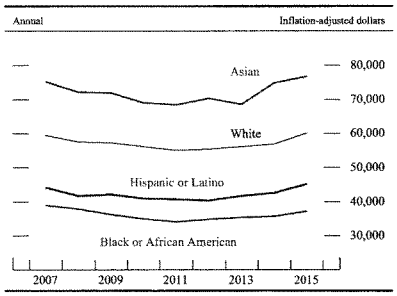
The Recovery from the Great Recession and Remaining Challenges

The Great Recession severely affected the U.S. economy . . .

The Great Recession of 2008 and 2009, and the financial crisis that precipitated it, resulted in massive job losses and falling incomes for American households. The Great Recession was, along many dimensions, the most severe downturn since the Great Depression almost 80 years earlier. Economic output declined outright for 18 months, leaving real gross domestic product (GDP) 4½ percent below its previous peak. More than 8½ million jobs were lost, on net, and the unemployment rate soared from 4½ percent in 2007 to a peak of 10 percent in late 2009 (text figure 3). The labor force participation rate (LFPR), the fraction of the population either employed or counted as unemployed, fell steeply, from 66 percent in 2007 to 63 percent in 2014 (text figure 2). Household incomes tumbled, with real income for the median family declining more than 8 percent from 2007 to 2012.

The hardships were particularly acute for certain groups of Americans. As text figure 4 shows, unemployment rates for blacks and Hispanics rose considerably more during the recession than did such rates for the nation as a whole. Of particular note, inflation-adjusted median household incomes for black households declined more than 12 percent from peak to trough, substantially more in percentage terms than for white, Hispanic, or Asian households (figure A).[1]

A. Median household income, by race and ethnicity



NOTE: Race refers to the race of the head of household. The Hispanic and Latino ethnicity and race categories are not mutually exclusive. Some individuals, for example, are both Hispanic and white, and they are represented in both lines.

SOURCE: Department of Commerce, Bureau of the Census (2016), *Income and Poverty in the United States: 2015*, Table A-1: Households by Total Money Income, Race, and Hispanic Origin of Householder: 1967 to 2015 (Washington: Census Bureau, September), www.census.gov/library/publications/2016/demo/p60-256.html.

. . . but considerable progress has been made

In the eight years since the crisis, the U.S. economy has made considerable progress across a broad range of measures; this progress has occurred while the resilience of the financial system has been shored up. More than 15 million jobs have been created, on net, since the fall of 2009, and the unemployment rate has fallen by half. In addition, the LFPR has moved roughly sideways since 2014, which should be viewed as a cyclical improvement given the demographic changes and other secular trends that have put downward pressure on participation for the past 10 years. The robust job gains seen during the current expansion are all the more noteworthy given these demographic pressures.

The labor market at present is likely close to being at full employment. The unemployment rate is near the median of Federal Open Market Committee (FOMC) participants' assessments of its longer-run normal value. In addition, real GDP now stands 11 percent above its pre-recession peak, and it is approaching, though still a bit below, the Congressional Budget Office's estimate of potential output—that is, the maximum sustainable level of economic output.[2]

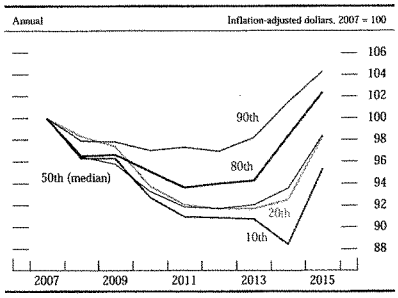
Incomes for the median family have mostly recovered from the Great Recession. Of note, real median income is reported to have risen 5.2 percent in 2015 (figure B).

The recovery compares favorably with those of other advanced economies. GDP has increased faster and unemployment has declined more quickly in the United States than in other major advanced economies (figures C and D). And the Federal Reserve's challenges in getting inflation back up to target are similar to, but not as severe as, those faced by some other major monetary authorities in the past few years. Although

1. Measures of household income derived from surveys—such as the Current Population Survey's Annual Social and Economic Supplement, which informs the Census Bureau's official statistics—may not fully capture earned income (such as from the self-employed) and unearned income (such as transfers and retirement income). These issues are likely to be much more pronounced for the various subgroups than they are for the national median.

2. Congressional Budget Office (2017), *The Budget and Economic Outlook: 2017 to 2027* (Washington: CBO, January), p. 41, www.cbo.gov/sites/default/files/115th-congress-2017-2018/reports/52370-outlook.pdf.

B. Indexed household income, by percentile



SOURCE: Department of Commerce, Bureau of the Census (2016), Income and Poverty in the United States: 2015, Table A-2: Selected Measures of Household Income Dispersion: 1967 to 2015 (Washington: Census Bureau, September), www.census.gov/library/publications/2016/demo/p60-256.html.

consumer price inflation, as measured by the price index for personal consumption expenditures, has run below the FOMC's 2 percent objective through most of the expansion, in recent months inflation has moved closer to the Committee's target (text figure 7).

Nonetheless, challenges remain

While much progress has been made, important challenges remain for the U.S. economy. GDP growth has averaged only about 2 percent per year during this expansion, the slowest pace of any postwar recovery (figure E). In part, that subdued pace is due to slower growth in the labor force in recent decades compared with much of the postwar period.[3]

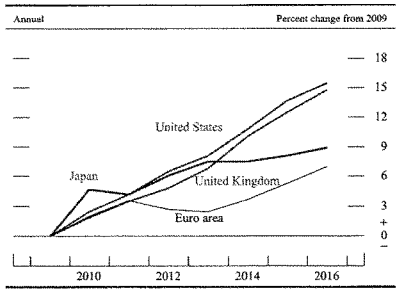
Another source of slow GDP growth has been lackluster labor productivity growth (text figure 6). Since 2008, output per hour in the business sector has risen about 1 percent per year, far below the pace that prevailed before the recession. Cyclical factors, like weak business investment and firms rebuilding workforces after cutting unusually deeply during the crisis, likely explain some of the slow rise in productivity during this expansion. But structural factors may also be at play, such as declines in innovation, reduced business dynamism, or decreased product market competition.[4] The productivity slowdown has taken place in most advanced economies, which suggests a role for structural factors not specific to the United States.

(continued on next page)

3. In particular, the Congressional Budget Office estimates that the contribution to potential GDP growth from trend labor force growth is 2 percentage points lower today than it was 40 years ago. This development reflects a slowing of population growth and a switch from a rising LFPR to a falling one, among other factors. See Congressional Budget Office, *Budget and Economic Outlook*, table 2-3, p. 58, in note 2.

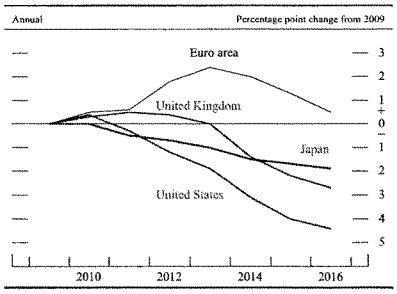
4. See Robert J. Gordon (2016), *The Rise and Fall of American Growth: The U.S. Standard of Living since the Civil War* (Princeton, N.J.: Princeton University Press); Steven J.

C. Real gross domestic product in international context



SOURCE: Organisation for Economic Co-operation and Development (2017), "OECD Economic Outlook No. 100 (Edition 2016/2)," OECD Economic Outlook: Statistics and Projections (database), http://dx.doi.org/10.1787/7fa317bf-en (accessed January 2017).

D. Unemployment rate in international context



SOURCE: Organisation for Economic Co-operation and Development (2017), "OECD Economic Outlook No. 100 (Edition 2016/2)," OECD Economic Outlook: Statistics and Projections (database), http://dx.doi.org/10.1787/7fa317bf-en (accessed January 2017).

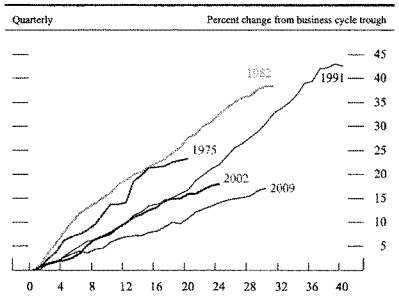
The Recovery from the Great Recession and Remaining Challenges *(continued)*

Meanwhile, despite the notable pickup in 2015, real incomes for the median family are still a bit lower than they were prior to the recession. Moreover, the gains have not been uniformly distributed; families at the 10th percentile of the income distribution earned about 4 percent less in 2015 than they did in 2007, while families at the 90th percentile earned about 4 percent more than before the Great Recession (figure B).

Similarly, the economic circumstances of blacks and Hispanics have improved since the depths of the recession, but they remain worse, on average, than those of whites or Asians. Unemployment rates for blacks and Hispanics continue to be well above those for their white and Asian counterparts (text figure 4), while incomes for these groups have stayed noticeably lower (figure A).

These challenges lie substantially beyond the reach of monetary policy to address. Monetary policy cannot, for instance, generate technological breakthroughs or address the root causes of inequality.

E. Real gross domestic product in historical context



NOTE: Real gross domestic product indexed to business cycle trough as dated by the National Bureau of Economic Research. The x-axis shows the number of quarters since the business cycle trough.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

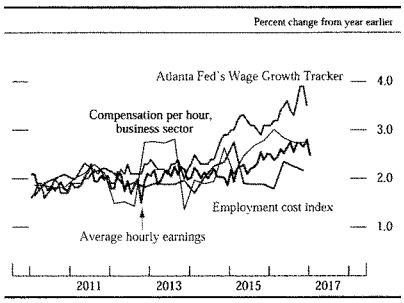
Davis and John Haltiwanger (2014), "Labor Market Fluidity and Economic Performance," NBER Working Paper Series 20479 (Cambridge, Mass.: National Bureau of Economic Research, September); and Philippe Aghion, Nick Bloom, Richard Blundell, Rachel Griffith, and Peter Howitt (2005), "Competition and Innovation: An Inverted-U Relationship," *Quarterly Journal of Economics*, vol. 120 (May), pp. 701–28.

Economists are divided about the causes of the productivity slowdown and their consequences for the outlook. For an optimistic view, see Erik Brynjolfsson and Andrew McAfee (2014), *The Second Machine Age: Work, Progress, and Prosperity in a Time of Brilliant Technologies* (New York: W.W. Norton & Company). For a less optimistic perspective, see Gordon, *Rise and Fall of American Growth*, earlier in this note. Others have argued that difficulties associated with economic measurement may exaggerate the slowdown; see, for example, David M. Byrne, John G. Fernald, and Marshall B. Reinsdorf (2016), "Does the United States Have a Productivity Slowdown or a Measurement Problem?" *Brookings Papers on Economic Activity*, Spring, pp. 109–57, https://www.brookings.edu/wp-content/uploads/2016/03/byrnetextspring16bpea.pdf. Another, more optimistic explanation is that the slowdown in productivity reflects a "constructive pause" as firms adopt new productivity-enhancing technology and organizational practices; see, for example, Paul A. David (1990), "The Dynamo and the Computer: An Historical Perspective on the Modern Productivity Paradox," *American Economic Review*, vol. 80 (May), pp. 355–61.

Labor compensation growth is picking up . . .

The improving labor market appears to be contributing to somewhat larger gains in labor compensation. Major BLS measures of hourly compensation posted larger increases last year. Of these, the measures that include the costs of benefits have posted smaller gains than wage-only measures because of a slowdown in the growth of employer health-care costs. A compensation measure computed by the Federal Reserve Bank of Atlanta, which tracks only the wages of workers who were employed at two points in time spaced 12 months apart, shows even more pickup than these BLS measures (figure 5).

5. Measures of change in hourly compensation

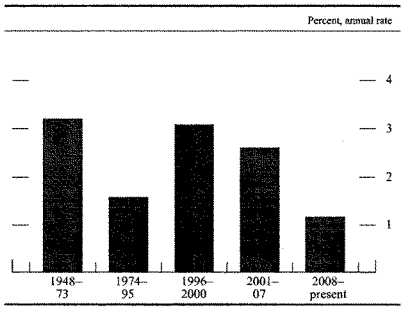


NOTE: Business-sector compensation is the four-quarter percentage change of the four-quarter moving average. For the employment cost index, change is over the 12 months ending in the last month of each quarter; for average hourly earnings, change is from 12 months earlier; for the Atlanta Fed's Wage Growth Tracker, the data are shown as a three-month moving average and extend through December 2016.
SOURCE: Department of Labor, Bureau of Labor Statistics; Federal Reserve Bank of Atlanta, Wage Growth Tracker.

. . . amid persistently slow productivity growth

As in the previous several years, gains in labor compensation last year occurred against a backdrop of persistently slow productivity growth. Since 2008, labor productivity gains have averaged around 1 percent per year, well below the pace that prevailed from the mid-1990s to 2007 and somewhat below the 1974–95 average of 1½ percent per year (figure 6). Since 2011, output per hour has averaged only a little more than ½ percent per year. The relatively slow pace of productivity growth in recent years is in part a consequence of the slower pace of capital accumulation; diminishing gains in technological innovations and downward trends in business formation also may have played a role.

6. Change in business-sector output per hour

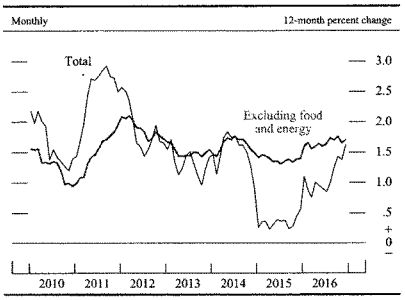


NOTE: Changes are measured from Q4 of the year immediately preceding the period through Q4 of the final year of the period. The final period is measured from 2007:Q4 through 2016:Q4.
SOURCE: Department of Labor, Bureau of Labor Statistics.

Price inflation has picked up over the past year . . .

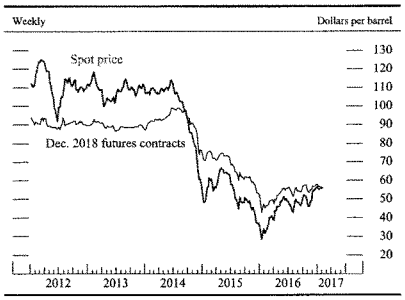
In recent years inflation has been persistently low, in part because the drop in oil prices and the rise in the exchange value of the dollar since mid-2014 have led to sharp declines in energy prices and relatively weak non-energy import prices. The effects of these earlier developments have been waning, however, and overall inflation has been moving up toward the FOMC's 2 percent target; the 12-month

7. Change in the price index for personal consumption expenditures



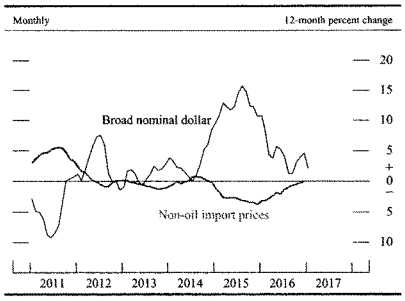
NOTE: The data extend through December 2016; changes are from one year earlier.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

8. Brent spot and futures prices



NOTE: The data are weekly averages of daily data and extend through February 9, 2017.
SOURCE: NYMEX via Bloomberg.

9. Non-oil import prices and U.S. dollar exchange rate



NOTE: The data for non-oil import prices extend through December 2016.
SOURCE: Department of Labor, Bureau of Labor Statistics; Federal Reserve Board, Statistical Release H.10, "Foreign Exchange Rates."

change in overall PCE prices reached 1.6 percent in December, compared with only 0.6 percent over 2015. The PCE price index excluding food and energy items, which provides a better indication than the headline figure of where overall inflation will be in the future, rose 1.7 percent over the 12 months ending in December, somewhat greater than the 1.4 percent increase in the prior year, as prices for a wide range of core goods and services accelerated. Nonetheless, the rate of inflation for both total and core PCE prices remains below the Committee's target (figure 7).

. . . as oil and other commodity prices moved up moderately

The similar readings for headline and core PCE inflation last year partly reflect an upturn in crude oil in 2016 following the sharp decline in the prior two years. Since July, oil prices traded mostly in the $45 to $50 per barrel range until the November OPEC agreement regarding production cuts in 2017 (figure 8). In the wake of that agreement, prices moved up to about $55, roughly $15 per barrel higher since late 2015. Retail gasoline prices also rose after the November OPEC agreement, but that increase has partially reversed in recent weeks.

After falling during 2014 and 2015, non-oil import prices stabilized in late 2016, supported by the rise in nonfuel commodity prices as well as by an uptick in foreign inflation (figure 9). In particular, prices of metals have increased in the past few months, boosted by production cuts combined with improved prospects for demand both in the United States and abroad. However, factors holding non-oil import prices down include dollar appreciation in the second half of 2016 and lower prices of agricultural goods last fall, as U.S. harvests hit record-high levels for many crops.

Survey measures of longer-term inflation expectations have been generally stable . . .

Wage- and price-setting decisions are likely influenced by expectations for inflation. Surveys of professional forecasters outside the Federal Reserve System indicate that their longer-term inflation expectations have remained stable and consistent with the FOMC's 2 percent objective for PCE inflation. In contrast, the median inflation expectation over the next 5 to 10 years as reported by the University of Michigan Surveys of Consumers has generally trended downward over the past few years, though it is little changed from a year ago; this measure was at 2.5 percent in early February (figure 10). It is unclear how best to interpret that downtrend; this measure of inflation expectations has been above actual inflation for much of the past 20 years.

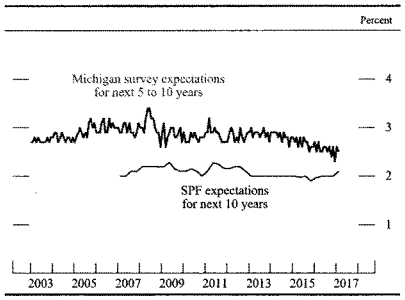
. . . and market-based measures of inflation compensation have moved up notably in recent months but also remain relatively low

TIPS-based inflation compensation (5 to 10 years forward), after declining to very low levels through the middle of 2016, has risen to nearly 2 percent and is about 20 basis points higher than it was at the end of 2015. However, this level is still below the 2½ to 3 percent range that persisted for most of the 10 years prior to 2014 (figure 11).

Real GDP growth picked up in the second half of 2016

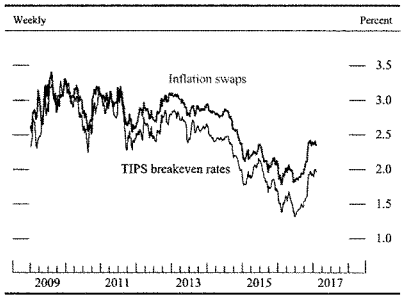
Real GDP is reported to have increased at an annual rate of 2¾ percent in the second half of 2016 after increasing just 1 percent in the first half (figure 12). Much of the step-up reflects the stabilization of inventory investment, which held down GDP growth considerably in the first half of last year, as well as a pickup in government purchases of goods and services. Private domestic final purchases—that is, final purchases by U.S. households

10. Median inflation expectations



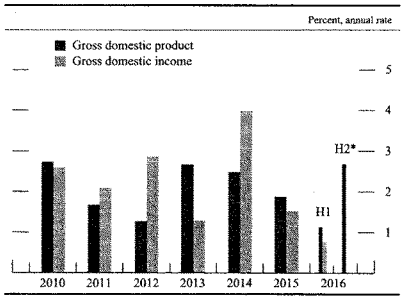
NOTE: The Michigan survey data are monthly and extend through February; the February data are preliminary. The SPF data for inflation expectations for personal consumption expenditures are quarterly and extend from 2007:Q1 through 2017:Q1.
SOURCE: University of Michigan Surveys of Consumers; Federal Reserve Bank of Philadelphia, Survey of Professional Forecasters (SPF).

11. 5-to-10-year-forward inflation compensation



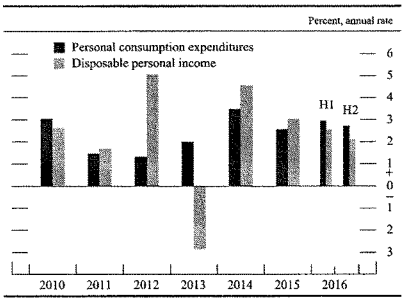
NOTE: The data are weekly averages of daily data and extend through February 10, 2017. TIPS is Treasury Inflation-Protected Securities.
SOURCE: Federal Reserve Bank of New York; Barclays; Federal Reserve Board staff estimates.

12. Change in real gross domestic product and gross domestic income



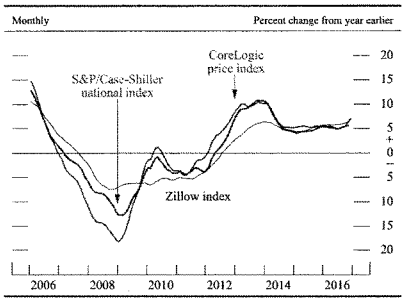
* Gross domestic income is not yet available for 2016:H2.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

13. Change in real personal consumption expenditures and disposable personal income



SOURCE: Department of Commerce, Bureau of Economic Analysis.

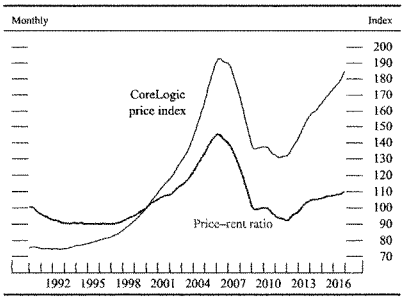
14. Prices of existing single-family houses



NOTE: The data for the S&P/Case-Shiller index extend through November 2016. The data for the Zillow and CoreLogic indexes extend through December 2016.

SOURCE: CoreLogic Home Price Index; Zillow; S&P/Case-Shiller U.S. National Home Price Index. The S&P/Case-Shiller Index is a product of S&P Dow Jones Indices LLC and/or its affiliates. (For Dow Jones Indices licensing information, see the note on the Contents page.)

15. Nominal house prices and price–rent ratio



NOTE: The data extend through December 2016. The CoreLogic price index is seasonally adjusted by Federal Reserve Board staff. The price–rent ratio is the ratio of nominal house prices to the consumer price index of rent of primary residence. The data are indexed to 100 in January 2000.

SOURCE: For prices, CoreLogic; for rents, Department of Labor, Bureau of Labor Statistics.

and businesses—grew more steadily than GDP last year and posted a fairly solid gain in the second half. PCE growth was bolstered by rising incomes and wealth, while private fixed investment was weak despite the low costs of borrowing for many households and businesses. Although the FOMC has increased the federal funds rate twice as this expansion has progressed—once in December 2015 and again in December 2016—in ¼ percentage point steps, overall financial conditions have been sufficiently accommodative to support somewhat-faster-than-trend growth in real activity.

Gains in income and wealth have continued to support consumer spending . . .

Real consumer spending rose at an annual rate of 2¾ percent in the second half of 2016, a solid pace similar to the one seen in the first half. Consumption has been supported by the ongoing improvement in the labor market and the associated increases in real disposable personal income (DPI)—that is, income after taxes and adjusted for price changes. Real DPI increased 2¼ percent in 2016 following a gain of 3 percent in 2015, when purchasing power was boosted by falling energy prices (figure 13).

Consumer spending has also been supported by further increases in household net worth. Broad measures of U.S. equity prices rose solidly over the past year, and house prices continued to move up (figure 14). (In nominal terms, national house prices are approaching their peaks of the mid-2000s, though relative to rents or income, house price valuations are much lower than a decade ago (figure 15).) Buoyed by these cumulative increases in home and equity prices, aggregate household net worth has risen appreciably from its level during the recession, and the ratio of household net worth to income remains well above its historical average (figure 16). The benefits of homeownership have not been distributed evenly; see the box "Homeownership by Race and Ethnicity."

. . . as does credit availability

Consumer credit has continued to expand somewhat faster than income amid stable delinquencies on consumer debt (figure 17). Auto and student loans remain widely available even to borrowers with lower credit scores, and outstanding balances on these types of loans continued to expand at a robust pace. Credit card balances continued to grow and were 6 percent higher than one year earlier in December. That said, credit card standards have remained tight for nonprime borrowers. As a result, delinquencies on credit cards are still near low historical levels.

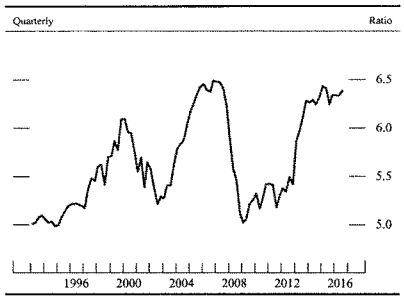
Consumer confidence is strong

Household spending has also been supported by favorable consumer sentiment. In 2015 and through most of 2016, readings from the overall index of consumer sentiment from the Michigan survey were solid, likely reflecting rising incomes and job gains. Sentiment has improved further in the past couple of months (figure 18). The share of households expecting real income gains over the next year or two is now close to its pre-recession level despite having lagged improvements in the headline sentiment measure earlier in the recovery.

Housing construction has been sluggish despite rising home demand

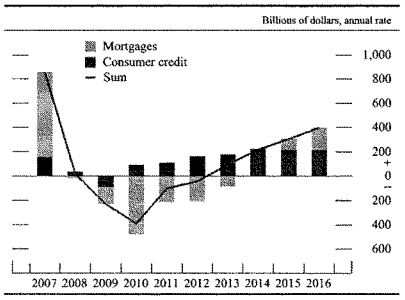
Residential investment spending appears to have only edged higher in 2016 following a larger gain in the previous year. Single-family housing starts registered a moderate increase in 2016, while multifamily housing starts flattened out on balance (figure 19). The pace of construction activity in 2016 remained sluggish despite solid gains in house prices and ongoing improvements in demand for both new and existing homes (figure 20). As a result, the months' supply of inventories of homes for sale dropped to low levels, and the aggregate vacancy rate moved to its lowest level since 2005. Reportedly, tight supplies of skilled labor and developed lots have been restraining home construction.

16. Wealth-to-income ratio



NOTE: The data extend through 2016:Q3. The series is the ratio of household net worth to disposable personal income.
SOURCE: For net worth, Federal Reserve Board, Statistical Release Z.1, "Financial Accounts of the United States"; for income, Department of Commerce, Bureau of Economic Analysis.

17. Changes in household debt



NOTE: Changes are calculated from year-end to year-end except 2016 changes, which are calculated from Q3 to Q3.
SOURCE: Federal Reserve Board, Statistical Release Z.1, "Financial Accounts of the United States."

18. Indexes of consumer sentiment and income expectations

NOTE: The data extend through February 2017; the February data are preliminary. The consumer sentiment data are monthly and are indexed to 100 in 1966. The real income expectations data are calculated as the net percentage of survey respondents expecting family income to go up more than prices during the next year or two plus 100 and are shown as a three-month moving average.
SOURCE: University of Michigan Surveys of Consumers.

Homeownership by Race and Ethnicity

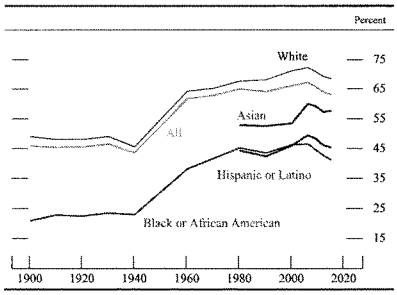
Most households in the United States own their homes, and among those who do not, many continue to aspire to own their homes.[1] The popularity of homeownership may stem from the amenities and financial benefits that are associated with ownership. For example, on the financial side, owning a home protects households against volatility in rental prices and may help them build wealth as they repay their mortgage.[2] Historically, we have seen disparities in homeownership across racial and ethnic groups, and these disparities are an important dimension of racial inequality in the United States.[3]

1. A 2014 survey indicated that over 90 percent of young renters reported that they intended to purchase a home in the future. See Fannie Mae (2014), *Fannie Mae National Housing Survey: What Younger Renters Want and the Financial Constraints They See* (Washington: Fannie Mae, May), www.fanniemae.com/resources/file/research/housingsurvey/pdf/nhsmay2014presentation.pdf.

2. See Todd Sinai and Nicholas S. Souleles (2005), "Owner-Occupied Housing as a Hedge against Rent Risk," *The Quarterly Journal of Economics*, vol. 120 (2), pp. 763–89; see also David Laibson (1997), "Golden Eggs and Hyperbolic Discounting," *Quarterly Journal of Economics*, vol. 112 (2), pp. 443–78. Of course, as the financial crisis made clear, homeownership carries risks as well. For example, highly leveraged homeowners are at risk of negative equity if house prices decline, which tends to impede mobility; see Fernando Ferreira, Joseph Gyourko, and Joseph Tracy (2010), "Housing Busts and Household Mobility," *Journal of Urban Economics*, vol. 68 (July), pp. 34–45.

3. Following standard practice, the homeownership rate is calculated here as the fraction of households that own their home. Thus, trends in household formation influence trends in the homeownership rate, and declining household formation in recent years has helped support the homeownership rate. See Andrew Paciorek (2016), "The Long and Short of Household Formation," *Real Estate Economics*, vol. 44 (1), pp. 7–40.

A. Homeownership rates, by race and ethnicity



NOTE: The data are every 10 years through 2000, except 1950; after 2000, the data are for 2006, 2009, 2012, and 2015. Persons whose ethnicity is identified as Hispanic or Latino may be of any race.

SOURCE: Department of Commerce, Bureau of the Census.

Nationally representative data from 1900 through 2015 indicate that the overall homeownership rate rose sharply from 1940 to 1960 (figure A).[4] Research suggests that this surge in homeownership reflected a combination of factors, including the postwar economic boom and an easing of terms for mortgage credit (such as reduced down payment requirements and longer terms to maturity) through government-backed lending programs run by the Federal Housing Administration and the Veterans Administration.[5] The homeownership rate then edged up slightly further, on net, between 1960 and 2006. However, since the onset of the housing crash and the financial crisis in 2007, the homeownership rate has declined as foreclosures became elevated for several years and first-time homebuying dropped and remained subdued.[6]

These post-crisis declines in homeownership have been similar for white, black, and Hispanic households and somewhat smaller for Asian households.[7] Thus, the large gaps between the homeownership rates of white households and those of black and Hispanic households have held steady, while the smaller gap between white and Asian households has narrowed slightly. Perhaps the most striking feature of the data is the persistence of the black–white homeownership gap, which has measured about 25 to 30 percentage points throughout the past 115 years. Potential reasons for this persistence will be discussed shortly.

The likelihood of owning one's home rises with age. Thus, the aging of the U.S. population contributed to increasing homeownership before 2006 and would

4. The data are decennial census data from 1900 through 2000 as well as American Community Survey (ACS) data from 2006, 2009, 2012, and 2015. For individual-level census and ACS data, see Steven Ruggles, Katie Genadek, Ronald Goeken, Josiah Grover, and Matthew Sobek (2015), Integrated Public Use Microdata Series: Version 6.0 [machine-readable database] (Minneapolis: University of Minnesota). The ACS has been conducted annually by the U.S. Census Bureau since 2000. Data on homeownership are not available in the 1950 census data.

5. See Daniel K. Fetter (2014), "The Twentieth-Century Increase in U.S. Home Ownership: Facts and Hypotheses," in Eugene N. White, Kenneth Snowden, and Price Fishback, eds., *Housing and Mortgage Markets in Historical Perspective* (Chicago: University of Chicago Press).

6. See Neil Bhutta (2015), "The Ins and Outs of Mortgage Debt during the Housing Boom and Bust," *Journal of Monetary Economics*, vol. 76, pp. 284–98.

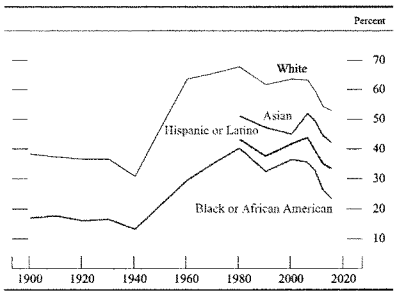
7. Households are classified by race and ethnicity according to the race and ethnicity of the household head, defined here as either the survey respondent or the spouse of the respondent if older. The Hispanic ethnicity and race categories are not mutually exclusive. Some individuals are, for example, both Hispanic and white. The Asian category includes Pacific Islanders. Homeownership rates for Hispanic and Asian households are not shown before 1980 because, prior to 1980, Hispanic status was not asked about directly and the Asian population was quite small.

have caused the homeownership rate to continue rising after 2006, all else being equal. Examining the data separately by age group reveals homeownership trends that differ from overall averages, with stronger declines in homeownership observed for young and middle-aged households. For example, among households headed by a person 30 to 39 years old, homeownership rates fell more than 10 percentage points between 2006 and 2015 for all major races and ethnicities (figure B).[8] For both white and black households in this age range, the homeownership rate peaked in 1980, much earlier than the overall national average; by 2015, it stood well below its level in 1960. Over the past century, the black–white homeownership gap has actually widened for households in this age range.

In light of the gains in education, income, and access to credit and housing over the long term for minorities in the United States, the persistence of the black–white gap is surprising. A considerable amount of academic research has sought to better understand differences in homeownership rates across racial and ethnic groups.[9] Many factors have been found to influence the likelihood of homeownership, and some of these may have had offsetting effects on the black–white gap. For example, from 1940 to 1960, the migration of many black families from the South to northern central cities (where owning a home was less likely regardless of race) tended to offset the positive effects on the homeownership rate from gains in income and education.[10]

In more recent decades, the relative rise in the fraction of black households headed by a single parent may have offset factors that otherwise would have generated increases in homeownership rates, including the introduction and enforcement of anti-discrimination laws, such as the Equal Credit Opportunity Act and the Fair Housing Act. Research on the black–white and Hispanic–white gaps indicates that a large portion of these gaps in recent years can be attributed to socioeconomic differences—such as age, income, and family structure—across groups.[11] That said, some of the overall gap is not explainable on the basis of those variables and could reflect other factors such as location and housing preferences; it also could reflect continued discrimination in housing and credit markets.[12] Finally, recent research has also documented larger differences in credit scores between whites and minorities than can be explained by income disparities; thus, the tighter mortgage credit environment that prevails today relative to a dozen or more years ago could cause the homeownership gap to widen in the near term.[13]

B. Homeownership rates, by race and ethnicity, for households headed by persons aged 30 to 39



NOTE: The data are every 10 years through 2000, except 1950; after 2000, the data are for 2006, 2009, 2012, and 2015. Persons whose ethnicity is identified as Hispanic or Latino may be of any race.
SOURCE: Department of Commerce, Bureau of the Census.

8. For more complete data on homeownership rates by age since 1900, see Laurie Goodman, Rolf Pendall, and Jun Zhu (2015), *Headship and Homeownership: What Does the Future Hold?* (Washington: Urban Institute, June), www.urban.org/sites/default/files/2000257-headship-and-homeownership-what-does-the-future-hold.pdf.

9. For a review of the literature, see Donald R. Haurin, Christopher E. Herbert, and Stuart S. Rosenthal (2007), "Homeownership Gaps among Low-Income and Minority Households," *Cityscape*, vol. 9 (2), pp. 5–52.

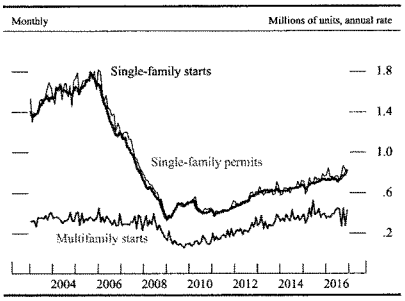
10. See William J. Collins and Robert A. Margo (2001), "Race and Home Ownership: A Century-Long View," *Explorations in Economic History*, vol. 38 (January), pp. 68–92.

11. See Stuart A. Gabriel and Stuart S. Rosenthal (2005), "Homeownership in the 1980s and 1990s: Aggregate Trends and Racial Gaps," *Journal of Urban Economics*, vol. 57 (January), pp. 101–27; and Eric Fesselmeyer, Kien T. Le, and Kiat Ying Seah (2012), "A Household-Level Decomposition of the White–Black Homeownership Gap," *Regional Science and Urban Economics*, vol. 42 (January), pp. 52–62.

12. See Kerwin Kofi Charles and Erik Hurst (2002), "The Transition to Home Ownership and the Black–White Wealth Gap," *Review of Economics and Statistics*, vol. 84 (May), pp. 281–97.

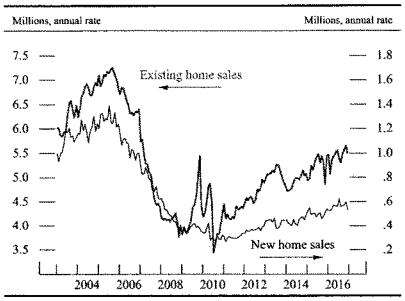
13. See Neil Bhutta and Daniel Ringo (2016), "Credit Availability and the Decline in Mortgage Lending to Minorities after the Housing Boom," FEDS Notes (Washington: Board of Governors of the Federal Reserve System, September 29), https://www.federalreserve.gov/econresdata/notes/feds-notes/2016/credit-availability-and-the-decline-in-mortgage-lending-to-minorities-after-the-housing-boom-20160929.html. For additional research on heightened credit score thresholds in recent years, see Steven Laufer and Andrew Paciorek (2016), "The Effects of Mortgage Credit Availability: Evidence from Minimum Credit Score Lending Rules," Finance and Economics Discussion Series 2016-098 (Washington: Board of Governors of the Federal Reserve System, December), https://www.federalreserve.gov/econresdata/feds/2016/files/2016098pap.pdf.

19. Private housing starts and permits



NOTE: The data extend through December 2016.
SOURCE: Department of Commerce, Bureau of the Census.

20. New and existing home sales



NOTE: The data extend through December 2016. New home sales includes only single-family sales. Existing home sales includes single-family, condo, townhome, and co-op sales.
SOURCE: For new home sales, Census Bureau; for existing home sales, National Association of Realtors.

21. Mortgage rates and housing affordability

NOTE: The housing affordability index data are monthly through November, and the mortgage rate data are weekly through February 9, 2017. At an index value of 100, a median-income family has exactly enough income to qualify for a median-priced home mortgage. Housing affordability is seasonally adjusted by Board staff.
SOURCE: For housing affordability index, National Association of Realtors; for mortgage rates, Freddie Mac Primary Mortgage Market Survey.

Homebuying and residential construction have been supported by low interest rates and ongoing easing of credit standards for mortgages. Banks indicated in the October 2016 Senior Loan Officer Opinion Survey on Bank Lending Practices (SLOOS) that they eased standards on several categories of residential home purchase loans.[1] Even so, mortgage credit is still relatively difficult to access for borrowers with low credit scores, harder-to-document income, or high debt-to-income ratios. Although mortgage rates moved up from their all-time low levels over the second half of last year, they remain quite low by historical standards, and, consequently, housing affordability remains favorable (figure 21).

Business investment may be turning up after a period of surprising weakness

Real outlays for business investment—that is, private nonresidential fixed investment—were generally weak in 2016 but posted larger gains toward the end of the year (figure 22). Last year's weakness occurred despite moderate increases in aggregate demand and generally favorable financing conditions, and it was widespread across categories of equipment investment. Investment in equipment and intangibles moved down over most of the year, likely reflecting the effects of the combination of low oil prices, weak export demand, and a muted longer-run demand outlook among businesses. Although such declines are unusual outside of a recession, spending on these items did turn up in the fourth quarter. Investment in drilling and mining structures, which had been falling sharply since the drop in oil prices in 2014, fell further through most of 2016 but seems to be bottoming out. Outside of the energy sector, investment in nonresidential structures increased moderately in 2016. Finally, after having been subdued for much of 2016, a widespread set of business sentiment indicators improved notably near the end of last year.

1. The SLOOS is available on the Board's website at https://www.federalreserve.gov/boarddocs/snloansurvey.

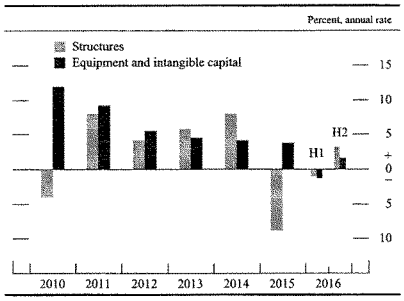
Financing conditions for nonfinancial firms have generally remained favorable

Nonfinancial businesses have continued to raise funds through bond issuance and bank loans, albeit at a somewhat slower pace than in the first half of 2016 (figure 23). The pace of such borrowing was supported in part by continued low interest rates: Corporate bond yields for speculative-grade borrowers have declined since last June, and those for investment-grade borrowers have increased but a fair bit less than those on comparable-maturity Treasury securities (figure 24). Banks indicated in the October 2016 and January 2017 SLOOS that they eased lending terms on commercial and industrial loans in the second half of the year, but that standards on such loans remained unchanged relative to earlier in 2016; banks continued to tighten standards on commercial real estate loans over the second half of last year.

Net exports held down second-half real GDP growth

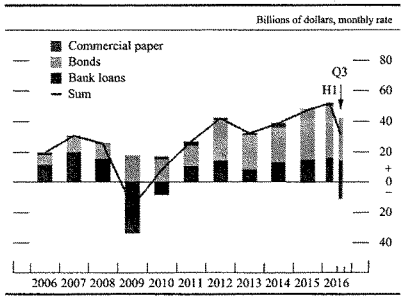
The rise in the dollar since mid-2014 and subdued foreign economic growth have continued to weigh on U.S. exports (figure 25). Nevertheless, exports increased at a moderate pace in the second half of 2016, but with much of the increase a result of rising agricultural exports. In particular, soybean exports surged in the third quarter before falling back toward a more normal level in the fourth quarter. Consistent with the stronger exchange value of the dollar, imports jumped in the second half of the year after having been about flat in the first half, when investment demand for imported equipment was very weak. Overall, real net exports were a moderate drag on real GDP growth in the second half of 2016. Although the trade balance and current account deficit narrowed slightly in the second and third quarters of 2016, the trade balance widened in the fourth quarter, as imports significantly outpaced exports (figure 26).

22. Change in real private nonresidential fixed investment



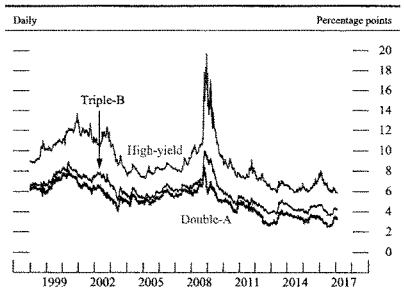
SOURCE: Department of Commerce, Bureau of Economic Analysis.

23. Selected components of net debt financing for nonfinancial businesses



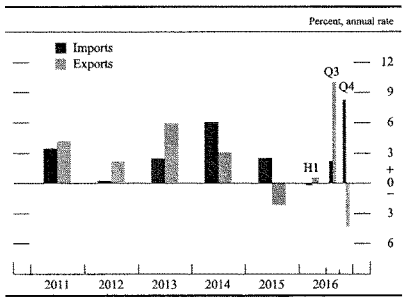
SOURCE: Federal Reserve Board, Statistical Release Z.1, "Financial Accounts of the United States."

24. Corporate bond yields, by securities rating



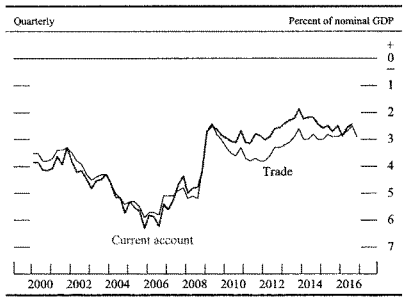
NOTE: The yields shown are yields on 10-year bonds.
SOURCE: BofA Merrill Lynch Global Research, used with permission.

25. Change in real imports and exports of goods and services



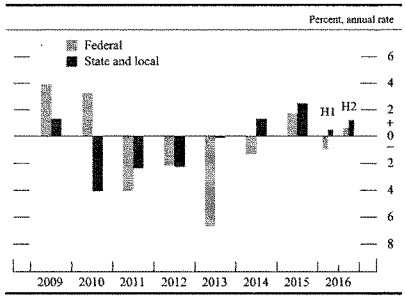
SOURCE: Department of Commerce, Bureau of Economic Analysis.

26. U.S. trade and current account balances



NOTE: The data for the current account extend through 2016:Q3. GDP is gross domestic product.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

27. Change in real government expenditures on consumption and investment



SOURCE: Department of Commerce, Bureau of Economic Analysis.

Federal fiscal policy was a roughly neutral influence on GDP growth in 2016 . . .

After being a drag on aggregate demand during much of the expansion, discretionary changes in federal fiscal policy have had a more neutral influence over the past two years. During 2016, policy actions had little effect on taxes and transfers, and federal purchases of goods and services are little changed over this period (figure 27). The federal budget deficit increased in fiscal year 2016 to 3.2 percent of GDP from 2.4 percent in fiscal 2015. Revenues rose only 1 percent last year in nominal terms and fell as a share of GDP because of soft personal income tax revenues and a decline in corporate income tax collections. Outlays rose 5 percent, edging up as a share of GDP, owing to increases in mandatory spending and interest payments as well as a shift in the timing of some payments that ordinarily would have been made in fiscal 2017 (figure 28). The Congressional Budget Office forecasts the deficit to be about the same size (as a share of GDP) in fiscal 2017 and in the next couple of years before rising thereafter. Consequently, the ratio of debt held by the public to nominal GDP is projected to remain near its current level of 77 percent of GDP for the next couple of years and then begin to rise (figure 29).

. . . and real purchases at the state and local level continue to increase, albeit at a tepid pace

The fiscal conditions of most state and local governments have continued to improve, though the pace of improvement has been slower in recent quarters than it had been previously. The ongoing improvement facilitated a step-up in the average pace of employment gain in the sector to the strongest rate since 2008. At the same time, however, real investment in structures by state and local governments has declined, on net, since the first quarter of 2016 after trending up during the prior two years (figure 30). All told, total real state and local purchases rose anemically in 2016. On the other side of the ledger,

revenue growth was subdued overall, with little growth in tax collections at the state level but moderate gains at the local level.

Financial Developments

The expected path for the federal funds rate over the next several years steepened

Against the backdrop of continued strengthening in the labor market and an increase in inflation over the course of 2016, the path of the federal funds rate implied by market quotes on interest rate derivatives has moved up, on net, since the middle of last year. Following the U.S. elections in November, the expected policy path in the United States steepened significantly, apparently reflecting investors' expectations of a more expansionary fiscal policy. Meanwhile, market-based measures of uncertainty about the policy rate approximately one to two years ahead also increased, on balance, suggesting that some of the firming in market rates may reflect a rise in term premiums.

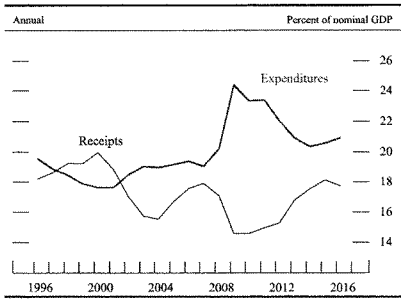
Survey-based measures of the expected path of policy also moved up in recent months. In the Survey of Primary Dealers that was conducted by the Federal Reserve Bank of New York just prior to the January 2017 FOMC meeting, the median dealer expected two rate hikes in 2017 and three rate hikes in 2018 as the most likely outcome.[2]

U.S. nominal Treasury yields increased considerably

After dropping significantly during the first half of 2016 and reaching near-historical lows in the aftermath of the U.K. referendum on exit from the European Union, or Brexit, in June, yields on medium- and longer-term nominal Treasury securities rebounded strongly in the second half of last year, with a substantial rise following the U.S.

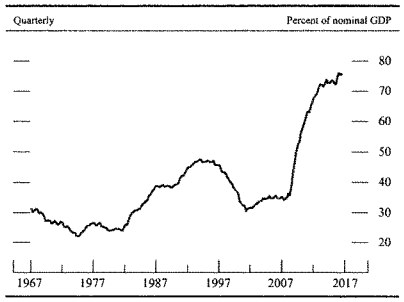
2. The Federal Reserve Bank of New York's Survey of Primary Dealers is available at https://www.newyorkfed.org/markets/primarydealer_survey_questions.html.

28. Federal receipts and expenditures



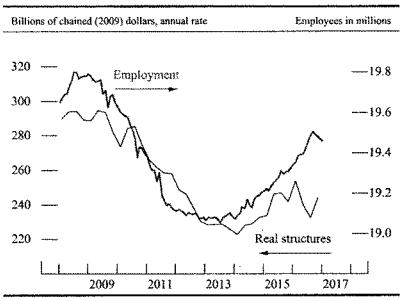
NOTE: The receipts and expenditures data are on a unified-budget basis and are for fiscal years (October through September); gross domestic product (GDP) data are for the four quarters ending in Q3.
SOURCE: Office of Management and Budget.

29. Federal government debt held by the public



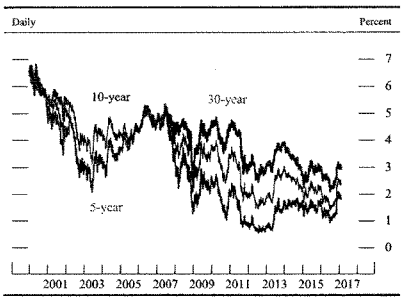
NOTE: The data extend through 2016:Q3. The data for gross domestic product (GDP) are at an annual rate. Federal debt held by the public equals federal debt less Treasury securities held in federal employee defined benefit retirement accounts, evaluated at the end of the quarter.
SOURCE: For GDP, Department of Commerce, Bureau of Economic Analysis; for federal debt, Federal Reserve Board, Statistical Release Z.1, "Financial Accounts of the United States."

30. State and local employment and structures investment



NOTE: The employment data are monthly, and the structures data are quarterly.
SOURCE: For employment data, Department of Labor, Bureau of Labor Statistics; for structures data, Department of Commerce, Bureau of Economic Analysis.

31. Yields on nominal Treasury securities



NOTE: The Treasury ceased publication of the 30-year constant maturity series on February 18, 2002, and resumed that series on February 9, 2006.
SOURCE: Department of the Treasury.

elections (figure 31). Market participants have attributed the increase in yields following the elections primarily to expectations of a more expansionary fiscal policy. The boost in longer-term nominal yields in recent months reflects roughly equal increases in real yields and inflation compensation. Consistent with the changes in Treasury yields, yields on 30-year agency mortgage-backed securities (MBS)—an important determinant of mortgage interest rates—increased significantly over the second half of the year (figure 32). However, Treasury and MBS yields remain quite low by historical standards.

Broad equity price indexes increased notably . . .

U.S. equity markets were volatile around the Brexit vote in the United Kingdom but operated without disruptions. Broad equity price indexes have increased notably since late June, with a sizable portion of the gain occurring after the U.S. elections in November (figure 33). Reportedly, equity prices have been supported in part by the perception that corporate tax rates may be reduced. Stock prices of banks, which tend to benefit from a steepening in the yield curve, outperformed the broader market. Moreover, market participants pointed to expectations of changes in the regulatory environment as a factor contributing to the outperformance of bank stocks. By contrast, stock prices of firms that tend to benefit from lower interest rates, such as utilities, declined moderately on net. The implied volatility of the S&P 500 index—the VIX— fell, ending the period close to the bottom of its historical range. (For a discussion of financial stability issues over this same period, see the box "Developments Related to Financial Stability.")

. . . while risk spreads on corporate bonds narrowed

Bond spreads in the nonfinancial corporate sector declined significantly across the credit spectrum, suggesting increased investor confidence in the outlook for the corporate

sector since the middle of last year. Declines in spreads were particularly large for firms in the energy sector, likely reflecting improved prospects for U.S. producers as they continue to increase efficiency and benefit from higher prices.

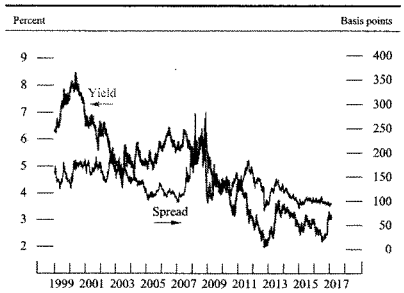
Treasury market functioning and liquidity conditions in the mortgage-backed securities market were generally stable

Indicators of Treasury market functioning remained broadly stable over the second half of 2016 and early 2017. A variety of liquidity metrics—including bid-asked spreads and bid sizes—have displayed minimal signs of liquidity pressures overall, with a modest reduction in liquidity following the U.S. elections. In addition, Treasury auctions generally continued to be well received by investors. Liquidity conditions in the agency MBS market were also generally stable.

The compliance deadline for money market mutual fund reform passed in mid-October with no market disruption

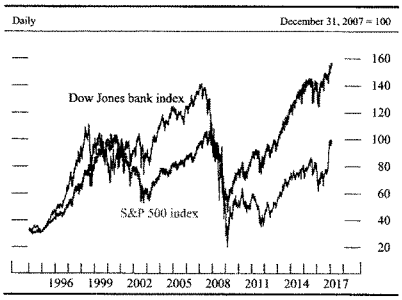
In the weeks leading up to the October 14, 2016, deadline for money market mutual funds (also referred to as money market funds, or MMFs) to comply with a variety of regulatory reforms, shifts in investments from prime to government MMFs were substantial. However, the transition was smooth and without any market disruptions. Overnight Eurodollar deposit volumes fell significantly and have remained low as prime funds pulled back from lending in this market. Meanwhile, the rise in total assets of government funds appeared to contribute to modestly higher levels of take-up at the overnight reverse repurchase agreement (ON RRP) facility through late 2016. Overnight money market rates were little affected, although the spread between the three-month LIBOR (London interbank offered rate) and the OIS (overnight index swap) rate has remained elevated, likely reflecting MMFs' reduced appetite for term lending.

32. Yield and spread on agency mortgage-backed securities



NOTE: The data are daily. Yield shown is for the Fannie Mae 30-year current coupon, the coupon rate at which new mortgage-backed securities would be priced at par, or face, value. Spread shown is to the average of the 5- and 10-year nominal Treasury yields.
SOURCE: Department of the Treasury; Barclays.

33. Equity prices



SOURCE: Standard & Poor's Dow Jones Indices via Bloomberg. (For Dow Jones Indices licensing information, see the note on the Contents page.)

Developments Related to Financial Stability

Financial vulnerabilities in the U.S. financial system overall have continued to be moderate since mid-2016. U.S. banks are well capitalized and have sizable liquidity buffers. Nonfinancial corporate business leverage has remained elevated by historical standards, and household borrowing has increased modestly, leaving the household debt-to-income ratio about unchanged. On balance, the ratio of aggregate nonfinancial credit to gross domestic product (GDP) has moved up a little in recent years to about its level in the mid-2000s but remains well below its recent peak. Valuation pressures in some asset classes have been rising, particularly late last year.

Vulnerabilities stemming from leverage in the financial sector appear low. Regulatory capital has remained at historically high levels for most large domestic banks, and all 33 firms participating in the Federal Reserve's supervisory stress tests for 2016 were able to maintain capital ratios above required minimums through the severely adverse recession scenario.[1] Moreover, market-based measures of leverage for domestic banks have decreased somewhat since November. However, valuations of many of the largest foreign banks remain depressed. Despite the settlement on December 23 between Deutsche Bank and the U.S. Department of Justice and some progress toward addressing problems in the Italian banking sector, several large European financial institutions have continued to be vulnerable to unexpected developments. Available data suggest that the leverage of nonbank financial institutions was relatively stable in the second half of 2016.

On balance, vulnerabilities associated with liquidity and maturity transformation are also somewhat below their longer-run average. The reliance of large bank holding companies on short-term funding remains subdued, and their holdings of high-quality liquid assets are robust, owing in part to the implementation of the Liquidity Coverage Ratio. Money market mutual fund (also referred to as money market fund, or MMF) reforms designed to reduce the advantages associated with being the first to exit a fund in times of financial stress led to large declines in prime MMF assets under management, with most of these funds migrating to government MMFs. While the resulting smaller size of prime funds and the new regulations should make the industry more stable, the longer-term effect will depend on the degree to which such activity migrates to other types of short-term investment vehicles that may be subject to similar fragilities.

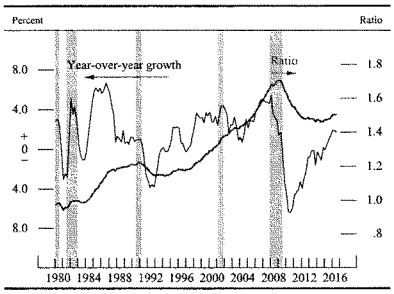
Asset valuation pressures have increased, on balance, since mid-2016, along with several indicators of investors' risk appetite. Although yields on Treasury securities and term premiums increased as market expectations about future growth shifted higher in the fall, they both remain low. In addition, the spread of yields on corporate bonds over those on comparable-maturity Treasury securities narrowed. Estimates of risk premiums in equity markets also declined. Outstanding riskier corporate debt edged down over the past year, but gross issuance of leveraged loans was strong and the share of bond issuance rated B or below remained in the fourth quarter at the high end of its range over the past few years. Commercial real estate (CRE) valuations, which have been an area of growing concern over the past year, rose further, with property prices continuing to climb and capitalization rates decreasing to historically low levels. While CRE debt remains modest relative to the overall size of the economy and the tightening in bank lending standards for CRE loans in the second half of last year may reflect some reduction in the appetite for CRE lending, the heightening of valuation pressures may leave some smaller banks vulnerable to a sizable CRE price decline. Also, residential home prices continued to rise briskly through November. Although most measures of residential valuation have moved up somewhat, they are still only modestly above the levels that would be predicted, given rents and investment costs. The results of the Federal Reserve's 2017 stress tests, for which the scenarios were released on February 3, will help gauge the vulnerability of large U.S. banks to all of these asset valuation pressures.

Vulnerabilities stemming from private nonfinancial-sector borrowing remain moderate. The credit-to-GDP ratio for the corporate sector is elevated after several years of rapid growth. Despite this high leverage, interest-expense ratios are low by historical standards even among higher-risk firms, as are measures of expected default based on accounting and stock return data, especially outside of the oil sector. Turning to households, debt growth was modest through the third quarter of 2016, and the debt-to-income ratio has changed little over the past few years. Except for a recent increase in early-payment delinquencies in subprime auto loans—a small segment of overall indebtedness—broad indicators of household solvency have remained within historical norms. On balance, the private nonfinancial-sector credit-to-GDP ratio is far below the levels seen late last decade and lies near its level in the mid-2000s (figure A).

Last fall, the Federal Reserve Board finalized its framework for setting the Countercyclical Capital Buffer

1. The 2016 supervisory stress-test methodology and results are available on the Board's website at https://www.federalreserve.gov/bankinforeg/stress-tests/2016-supervisory-stress-test-results.htm.

A. Private nonfinancial sector credit-to-GDP ratio



NOTE: The data on the credit-to-GDP ratio and its year-over-year growth are quarterly and extend through 2016:Q3. The shaded bars indicate periods of business recession as defined by the National Bureau of Economic Research.

SOURCE: Federal Reserve Board, Statistical Release Z.1, "Financial Accounts of the United States"; Bureau of Economic Analysis, national income and product accounts (NIPA); Board staff calculations.

(CCyB) and later voted to maintain the CCyB at zero.[2] In forming its view about the appropriate size of the U.S. CCyB, the Board intends to monitor a wide range of financial and economic indicators and consider their implications for financial system vulnerabilities, including but not limited to asset valuation pressures, risk appetite, leverage in the financial and nonfinancial sectors, and maturity and liquidity transformation in the financial sector. The decision to maintain the CCyB at zero in part reflected an assessment that vulnerabilities associated with financial-sector leverage were at the lower end of their historical ranges.

As part of its effort to improve the resilience of financial institutions and overall financial stability, the Board has also taken several further regulatory steps. Among those steps is that the Board finalized a rule that would impose total loss-absorbing capacity and long-term debt requirements on U.S. global systemically important bank holding companies (G-SIBs) and on the U.S. operations of certain foreign G-SIBS.[3] The final rule would require each covered firm to maintain a minimum amount of unsecured long-term debt that could be converted into equity in a possible resolution of that firm, thereby recapitalizing the firm without putting taxpayer funds at risk and diminishing the threat that its failure would pose to financial stability.

In addition, the Board completed an extensive review of its statutory stress-test and Comprehensive Capital Analysis and Review (CCAR) programs and made some related modifications to the rules associated with those programs for the 2017 cycle.[4] Among other changes, the Board removed certain large, noncomplex firms from the qualitative assessment of the CCAR.[5] Moreover, the Board, together with the other federal banking agencies, issued an advance notice of proposed rulemaking, inviting public comment on a set of potential enhanced cybersecurity risk-management and resilience standards that would apply to depository institutions and regulated holding companies with over $50 billion in assets and to certain financial market infrastructure companies.[6] The standards would be tiered, with an additional set of higher standards for systems that provide key functionality to the financial sector.

The Board and the Federal Deposit Insurance Corporation (FDIC) also have continued to actively engage in the resolution-planning process with the largest banks. As part of that process, the Board and the FDIC announced that Bank of America, BNY Mellon, JPMorgan Chase, and State Street adequately remediated deficiencies in their 2015 resolution plans. The two agencies also announced that Wells Fargo did not adequately remedy all of its deficiencies and will be subject to restrictions on certain activities until the deficiencies are remedied.[7]

2. See Board of Governors of the Federal Reserve System (2016), "Federal Reserve Board Announces It Has Voted to Affirm Countercyclical Capital Buffer (CCyB) at Current Level of 0 Percent," press release, October 24, https://www.federalreserve.gov/newsevents/press/bcreg/20161024a.htm.

3. See Board of Governors of the Federal Reserve System (2016), "Federal Reserve Board Adopts Final Rule to Strengthen the Ability of Government Authorities to Resolve in Orderly Way Largest Domestic and Foreign Banks Operating in the United States," press release, December 15, https://www.federalreserve.gov/newsevents/press/bcreg/20161215a.htm.

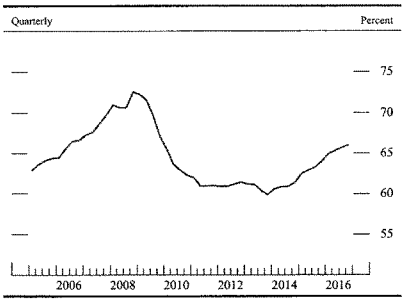
4. See Daniel K. Tarullo (2016), "Next Steps in the Evolution of Stress Testing," speech delivered at the Yale University School of Management Leaders Forum, New Haven, Conn., September 26, https://www.federalreserve.gov/newsevents/speech/tarullo20160926a.htm.

5. See Board of Governors of the Federal Reserve System (2017), "Federal Reserve Board Announces Finalized Stress Testing Rules Removing Noncomplex Firms from Qualitative Aspect of CCAR Effective for 2017," press release, January 30, https://www.federalreserve.gov/newsevents/press/bcreg/20170130a.htm.

6. See Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, and Federal Deposit Insurance Corporation (2016), "Agencies Issue Advanced Notice of Proposed Rulemaking on Enhanced Cyber Risk Management Standards," joint press release, October 19, https://www.federalreserve.gov/newsevents/press/bcreg/20161019a.htm.

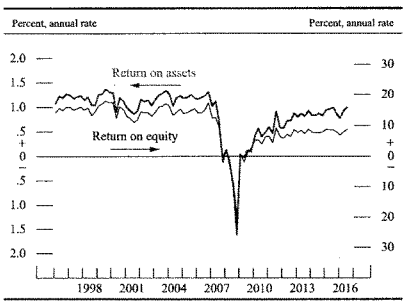
7. See Board of Governors of the Federal Reserve System and Federal Deposit Insurance Corporation (2016), "Agencies Announce Determinations on October Resolution Plan Submissions of Five Systemically Important Domestic Banking Institutions," joint press release, December 13, https://www.federalreserve.gov/newsevents/press/bcreg/20161213a.htm.

34. Ratio of total commercial bank credit to nominal gross domestic product



SOURCE: Federal Reserve Board, Statistical Release H.8, "Assets and Liabilities of Commercial Banks in the United States"; Department of Commerce, Bureau of Economic Analysis.

35. Profitability of bank holding companies



NOTE: The data, which are seasonally adjusted, are quarterly and extend through 2016:Q3.
SOURCE: Federal Reserve Board, Form FR Y-9C, Consolidated Financial Statements for Bank Holding Companies.

Bank credit continued to expand, and bank profitability improved

Aggregate credit provided by commercial banks continued to grow at a solid pace in the second half of 2016 (figure 34). The expansion in bank credit was driven by strong growth in core loans coupled with an increase in banks' holdings of securities. Measures of bank profitability improved since the middle of last year but remained below their historical averages (figure 35).

Municipal bond markets continued to function smoothly

Credit conditions in municipal bond markets have generally remained stable since late June. Over that period, the MCDX—an index of credit default swap spreads for a broad portfolio of municipal bonds—decreased moderately, while yield spreads on 20-year general obligation municipal bonds over comparable-maturity Treasury securities were little changed on balance. The Puerto Rico Oversight, Management, and Economic Stability Act was passed into law in late June, providing the commonwealth with a clearer path toward debt restructuring. Although Puerto Rico missed a small amount of debt payments on general obligation bonds in August, this default appeared to have had no significant effect on the broader municipal bond market.

International Developments

Foreign financial market conditions improved despite global political uncertainties

Financial market conditions in both the advanced foreign economies (AFEs) and the emerging market economies (EMEs) have generally improved since June. In the AFEs, increasing distance from the Brexit vote, better-than-expected economic data for Europe, and the continuation of accommodative monetary policies by advanced-economy central banks have

contributed to improved risk sentiment. Advanced-economy bond yields reversed their downward trend seen in the first half of the year and increased notably following the U.S. elections, in part on expectations of a more expansionary U.S. fiscal policy (figure 36).

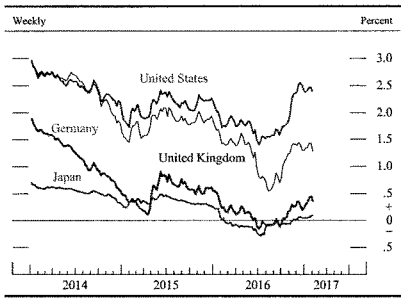
Equity prices in the AFEs have generally risen since June, with financial stocks outperforming broader stock indexes as third-quarter earnings largely beat expectations, several major risk events passed, and the steepening of yield curves was expected to boost profits going forward (figure 37). Despite some widening of euro-area corporate spreads in the last months of 2016, corporate credit conditions in the advanced foreign economies have remained accommodative, with the continuation of corporate asset purchase programs by several AFE central banks and with low corporate spreads.

In EMEs, equities have risen significantly and sovereign yield spreads have narrowed since June, supported in part by higher commodity prices. Financial conditions did tighten briefly following the U.S. elections, with increased capital outflows and wider sovereign spreads, on concerns that higher global interest rates, as well as the possibility of more protectionist trade policies, would weigh on EME growth (figure 38). However, the favorable risk sentiment seen in the summer and early fall of 2016 resumed by the end of the year for most EMEs.

After depreciating slightly in the first half of last year, the dollar strengthened in the second half

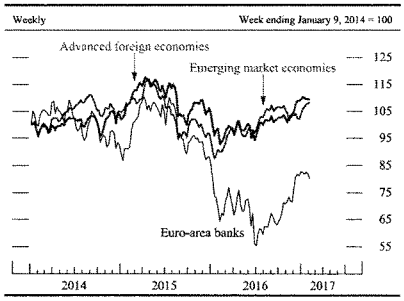
The dollar has strengthened since June, with the broad dollar index—a measure of the trade-weighted value of the dollar against foreign currencies—rising about 4 percent on balance (figure 39). Much of this strengthening of the U.S. dollar reflects the combined influences of the large depreciation of the Mexican peso, expectations of fiscal and trade policy changes after the U.S. elections, and

36. 10-year nominal benchmark yields in selected advanced economies



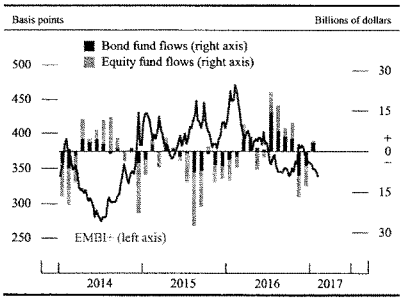
NOTE: The data are weekly averages of daily data and extend through February 9, 2017.
SOURCE: Bloomberg.

37. Equity indexes for selected foreign economies



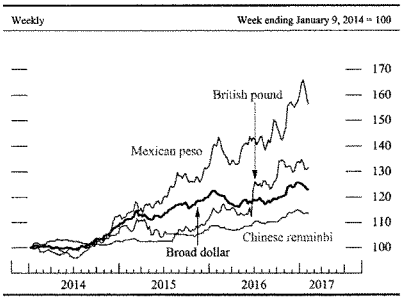
NOTE: The data are weekly averages of daily data and extend through February 9, 2017.
SOURCE: For advanced foreign economies, MSCI EAFE Index via Thomson Reuters Datastream; for emerging market economies, MSCI Emerging Markets Index via Thomson Reuters Datastream; for euro-area banks, Dow Jones Euro STOXX Bank Index via Bloomberg. (For Dow Jones Indices licensing information, see the note on the Contents page.)

38. Emerging market mutual fund flows and spreads



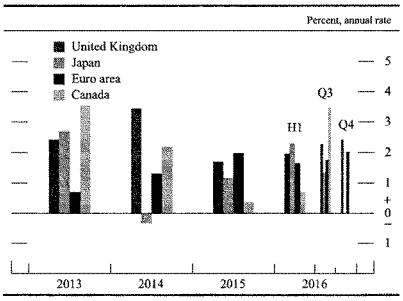
NOTE: The EMBI+ data are weekly averages of daily data and extend through February 9, 2017. The EPFR data are monthly sums of weekly data. The fund flows data exclude funds located in China.
SOURCE: For bond and equity fund flows, EPFR Global; for EMBI+, J.P. Morgan Emerging Markets Bond Index Plus via Bloomberg.

39. U.S. dollar exchange rate indexes



NOTE: The data, which are in foreign currency units per dollar, are weekly averages of daily data and extend through February 9, 2017.
SOURCE: Federal Reserve Board, Statistical Release H.10, "Foreign Exchange Rates."

40. Real gross domestic product growth in selected advanced foreign economies



NOTE: The data for the United Kingdom incorporate the flash estimate for 2016:Q4. The data for the euro area incorporate the preliminary flash estimate for 2016:Q4. The data for Japan and Canada extend through 2016:Q3.
SOURCE: For the United Kingdom, Office for National Statistics; for Japan, Cabinet Office, Government of Japan; for the euro area, Eurostat; for Canada, Statistics Canada; all via Haver Analytics.

market expectations of tighter Federal Reserve monetary policy. The Chinese renminbi also weakened notably against the dollar, on net, as capital outflows from China picked up; Chinese authorities tightened capital controls in response.

In general, AFE economic growth was moderate and inflation remained subdued

In Canada, economic growth picked up sharply in the third quarter, following a contraction in the previous quarter, as oil extraction recovered from the disruptions caused by wildfires in May (figure 40). In contrast, economic growth in Japan in the second and third quarters slowed after a strong first quarter, returning to a more typical moderate pace. Euro-area growth firmed in the second half, and, in the United Kingdom, economic activity was resilient in the aftermath of the Brexit referendum in June. Available indicators suggest that growth in most AFEs was moderate near the end of 2016 and early this year.

Headline inflation in most AFEs increased over the second half of 2016, in part driven by higher oil prices. In the United Kingdom, the substantial sterling depreciation after the Brexit referendum also exerted upward pressure on consumer prices. Even so, core inflation readings in AFEs remained generally subdued, and headline inflation stayed below central bank targets in Canada, the euro area, Japan, and the United Kingdom (figure 41).

AFE central banks maintained highly accommodative monetary policies

In August, the Bank of England cut its policy rate 25 basis points, announced additional purchases of government and corporate bonds, and introduced a term funding scheme. In September, the Bank of Japan committed to expanding the monetary base until inflation exceeds 2 percent in a stable manner and adopted a new policy framework aimed at controlling the yield curve by targeting short-

and long-term interest rates. In December, the European Central Bank announced an extension of the intended duration of its asset purchases through at least December 2017, albeit with a slight reduction in those purchases beginning in April 2017.

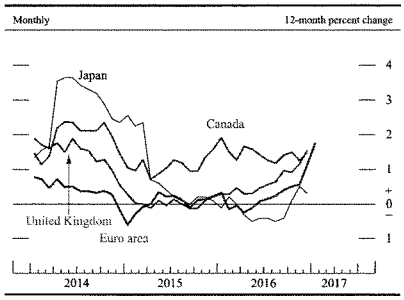
In EMEs, Asian growth was solid . . .

Chinese economic activity remained robust in the second half of 2016, as earlier policy easing supported stable manufacturing growth and a strong property market (figure 42). However, the property market cooled somewhat toward the end of the year following the introduction of new macroprudential measures aimed at curbing rapidly rising house prices. Elsewhere in emerging Asia, growth held steady in the third quarter but stepped down in some countries in the fourth, even though exports and manufacturing improved. And in India, a surprise mandatory exchange of large-denomination bank notes—a move aimed at battling tax evasion and corruption—has disrupted activity.

. . . but many Latin American economies continued to struggle

In Mexico, after considerable weakness in the first half of 2016, growth surged in the third quarter, supported in part by a recovery in exports to the United States. However, activity weakened again in the fourth quarter, as consumer and business confidence dropped. Furthermore, inflation in Mexico jumped over the second half of the year, pressured in part by the peso's sizable depreciation, prompting the Bank of Mexico to hike its policy rate sharply. Brazil's recession deepened in the third quarter, reflecting in part tight macroeconomic policies, although the central bank began to ease monetary policy as inflation dropped in response to the weak economy. Elsewhere in the region, activity in the third quarter was mixed; Chile's economy rebounded, but Argentina's GDP contracted and the crisis in Venezuela deepened.

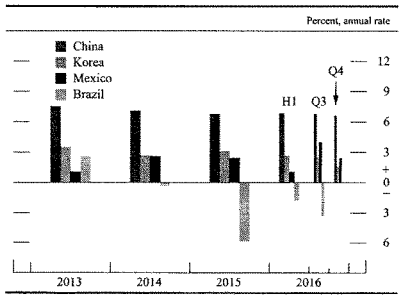
41. Inflation in selected advanced foreign economies



NOTE: The data for the euro area incorporate the flash estimate for January 2017. The data for Canada, Japan, and the United Kingdom extend through December 2016.

SOURCE: For the United Kingdom, Office for National Statistics; for Japan, Ministry of International Affairs and Communications; for the euro area, Statistical Office of the European Communities; for Canada, Statistics Canada; all via Haver Analytics.

42. Real gross domestic product growth in selected emerging market economies



NOTE: The data for Mexico incorporate the flash estimate for 2016:Q4. The data for China are seasonally adjusted by Board staff. The data for Mexico, Brazil, and Korea are seasonally adjusted by their respective government agencies. The data for Brazil extend through 2016:Q3.

SOURCE: For China, China National Bureau of Statistics; for Korea, Bank of Korea; for Mexico, Instituto Nacional de Estadistica y Geografia; for Brazil, Instituto Brasileiro de Geografia e Estatistica; all via Haver Analytics.

Part 2
Monetary Policy

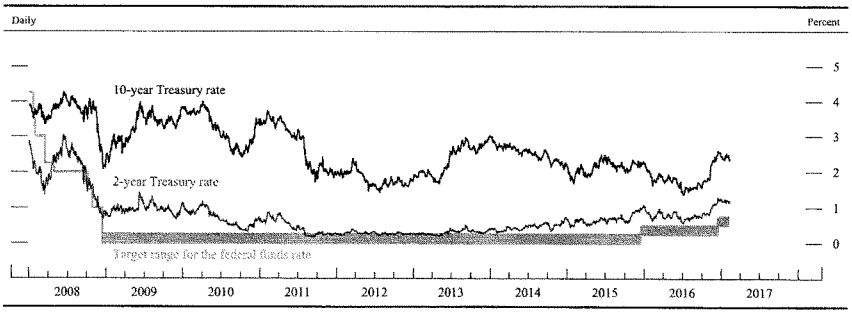
In December, the Federal Open Market Committee (FOMC) raised the target for the federal funds rate by ¼ percentage point to a range of ½ to ¾ percent. The FOMC's decision reflected realized and expected labor market conditions and inflation. Moreover, the decision to raise the target range was consistent with the Committee's expectation that, with gradual adjustments in the stance of monetary policy, economic activity would expand at a moderate pace, labor market conditions would strengthen somewhat further, and inflation would rise to the FOMC's 2 percent objective over the medium term. The Committee expects that economic conditions will evolve in a manner that will warrant only gradual increases in the federal funds rate; the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run. However, the actual path of the federal funds rate will depend on the economic outlook as informed by incoming data. In addition, the Committee anticipates reinvesting principal payments of its securities holdings until normalization of the level of the federal funds rate is well under way.

The FOMC raised the federal funds rate target range in December

About a year ago, in December 2015, the FOMC raised the target range for the federal funds rate after holding the range at near zero since late 2008 to support economic activity and stem disinflationary pressures in the wake of the Great Recession. At that time, the Committee judged that it had seen sufficient improvement in the labor market and was reasonably confident that inflation would move back to its 2 percent objective, which would warrant an initial increase in the federal funds rate. Through most of 2016, the Committee maintained the target range of ¼ to ½ percent, pending further evidence of continued progress toward its objectives. In December, in view of realized and expected labor market conditions and inflation, the FOMC raised the target range for the federal funds rate another ¼ percentage point, to a range of ½ to ¾ percent (figure 43).[3] The Committee kept that same target range at its most recent meeting, which concluded on February 1.

3. See Board of Governors of the Federal Reserve System (2016), "Federal Reserve Issues FOMC Statement," press release, December 14, https://www.federalreserve.gov/newsevents/press/monetary/20161214a.htm.

43. Selected interest rates



NOTE: The 2-year and 10-year Treasury rates are the constant-maturity yields based on the most actively traded securities.
SOURCE: Department of the Treasury; Federal Reserve Board.

Monetary policy continues to support the economic expansion

The Committee has continued to see the federal funds rate as likely to remain, for some time, below the levels that are expected to prevail in the longer run. With gradual adjustments in the stance of monetary policy, the FOMC expects that economic activity will expand at a moderate pace, labor market conditions will strengthen somewhat further, and inflation will rise to 2 percent over the medium term.

Consistent with this outlook, in the most recent Summary of Economic Projections (included as Part 3 of this report), which was compiled at the time of the December 2016 meeting, most participants projected that the appropriate level of the federal funds rate would be below its longer-run level through 2018.

Future changes in the federal funds rate will depend on the economic outlook as informed by incoming data

Although the Committee has expected that economic conditions will evolve in a manner that will warrant only gradual increases in the federal funds rate, the Committee has continued to emphasize that the actual path of monetary policy will depend on the evolution of the economic outlook. In determining the timing and size of future adjustments to the target range for the federal funds rate, the Committee will assess realized and expected economic conditions relative to its objectives of maximum employment and 2 percent inflation. This assessment will take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial and international developments. In light of the current shortfall of inflation from 2 percent, the Committee has indicated that it will carefully monitor actual and expected progress toward its inflation goal.

The size of the Federal Reserve's balance sheet has remained stable

To help maintain accommodative financial conditions, the Committee has continued its existing policy of rolling over maturing Treasury securities at auction and reinvesting principal payments on all agency debt and agency mortgage-backed securities in agency mortgage-backed securities. The Federal Reserve's total assets have held steady at around $4.5 trillion, with holdings of U.S. Treasury securities at $2.5 trillion and holdings of agency debt and agency mortgage-backed securities at approximately $1.8 trillion (figure 44). The Committee has for some time stated that it anticipates maintaining this policy until normalization of the level of the federal funds rate is well under way.

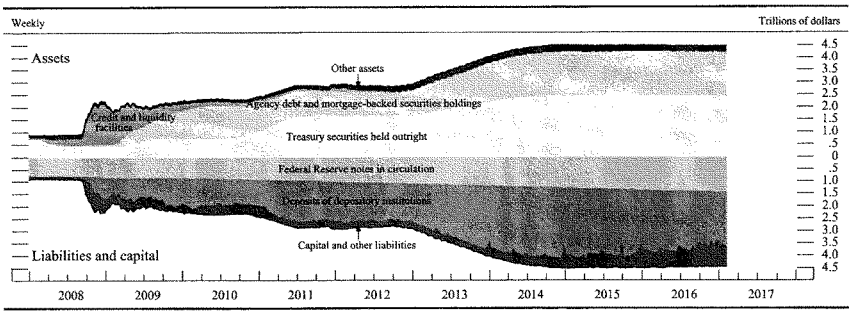
Interest income on the System Open Market Account, or SOMA, portfolio has continued to support substantial remittances to the U.S. Treasury. Preliminary results indicate that the Reserve Banks provided for payments of $92 billion of their estimated 2016 net income to the Treasury. The Federal Reserve's remittances to the Treasury have averaged about $80 billion a year since 2008, compared with about $25 billion a year over the decade prior to 2008.[4]

The Federal Reserve's implementation of monetary policy has continued smoothly

As in December 2015, the Federal Reserve successfully raised the effective federal funds rate in December 2016 using the interest rate paid on reserve balances, together with an overnight reverse repurchase agreement

4. Total remittances include a one-time transfer of $19.3 billion in December 2015 to reduce the aggregate Reserve Bank capital surplus to $10 billion, as required by the Fixing America's Surface Transportation Act. See Board of Governors of the Federal Reserve System (2016), "Federal Reserve System Publishes Annual Financial Statements," press release, March 18, https://www.federalreserve.gov/newsevents/press/other/20160317a.htm.

44. Federal Reserve assets and liabilities



NOTE: "Credit and liquidity facilities" consists of primary, secondary, and seasonal credit; term auction credit; central bank liquidity swaps; support for Maiden Lane, Bear Stearns, and AIG; and other credit facilities, including the Primary Dealer Credit Facility, the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, the Commercial Paper Funding Facility, and the Term Asset-Backed Securities Loan Facility. "Other assets" includes unamortized premiums and discounts on securities held outright. "Capital and other liabilities" includes reverse repurchase agreements, the U.S. Treasury General Account, and the U.S. Treasury Supplementary Financing Account. The data extend through February 8, 2017.

SOURCE: Federal Reserve Board, Statistical Release H.4.1, "Factors Affecting Reserve Balances."

(ON RRP) facility.[5] Specifically, the Federal Reserve raised the interest rate paid on required and excess reserve balances to ¾ percent and the ON RRP offering rate to ½ percent. In addition, the Board of Governors approved an increase in the discount rate (the primary credit rate) to 1.25 percent. The effective federal funds rate rose into the new range amid orderly trading conditions in money markets. Increases in interest rates in other money markets were similar to the rise in the federal funds rate following the December meeting.

The total take-up at the ON RRP facility increased modestly in the second half of 2016 as a result of higher demand by government money market mutual funds in the wake of money fund reform that took effect in mid-October.

Although the implementation of monetary policy has been smooth, the Federal Reserve has continued to test the operational readiness of other policy tools as part of prudent planning. Two operations of the Term Deposit Facility were conducted in the second half of 2016; seven-day deposits were offered at both operations with a floating rate of 1 basis point over the interest rate on excess reserves. In addition, the Open Market Desk conducted several small-value exercises solely for the purpose of maintaining operational readiness.

5. See Board of Governors of the Federal Reserve System (2014), "Federal Reserve Issues FOMC Statement on Policy Normalization Principles and Plans," press release, September 17, https://www.federalreserve.gov/newsevents/press/monetary/20140917c.htm.

Part 3
Summary of Economic Projections

The following material appeared as an addendum to the minutes of the December 13–14, 2016, meeting of the Federal Open Market Committee.

In conjunction with the Federal Open Market Committee (FOMC) meeting held on December 13–14, 2016, meeting participants submitted their projections of the most likely outcomes for real output growth, the unemployment rate, and inflation for each year from 2016 to 2019 and over the longer run.[6] Each participant's projection was based on information available at the time of the meeting, together with his or her assessment of appropriate monetary policy, including a path for the federal funds rate and its longer-run value, and assumptions about other factors likely to affect economic outcomes. The longer-run projections represent each participant's assessment of the value to which each variable would be expected to converge, over time, under appropriate monetary policy and in the absence of further shocks to the economy. "Appropriate monetary policy" is defined as the future path of policy that each participant deems most likely to foster outcomes for economic activity and inflation that best satisfy his or her individual interpretation of the Federal Reserve's objectives of maximum employment and stable prices.

Most FOMC participants expected that, under appropriate monetary policy, growth in real gross domestic product (GDP) would pick up a bit next year and run at or slightly above their individual estimates of its longer-run rate through 2019. Almost all participants projected that the unemployment rate would run below their estimates of its longer-run normal level in 2017 and remain below that level through 2019. All participants projected that inflation, as measured by the four-quarter percentage change in the price index for personal consumption expenditures (PCE), would increase over the next two years, and several expected inflation to slightly exceed the Committee's 2 percent objective in 2018 or 2019. Table 1 and figure 1 provide summary statistics for the projections.

As shown in figure 2, almost all participants expected that the evolution of economic conditions would warrant only gradual increases in the federal funds rate to achieve and sustain maximum employment and 2 percent inflation. Many participants judged that the appropriate level of the federal funds rate in 2019 would be close to their estimates of its longer-run normal level. However, the economic outlook is uncertain, and participants noted that their economic projections and assessments of appropriate monetary policy may change in response to incoming information.

A majority of participants viewed the level of uncertainty associated with their individual forecasts for economic growth, unemployment, and inflation as broadly similar to the norms of the previous 20 years, though some participants saw uncertainty associated with their forecasts as higher than average. Most participants also judged the risks around their projections for economic activity, the unemployment rate, and inflation as broadly balanced, while several participants saw the risks to their forecasts of real GDP growth as weighted to the upside and the risks to their unemployment rate forecasts as tilted to the downside.

6. One participant did not submit longer-run projections for real output growth, the unemployment rate, or the federal funds rate.

Table 1. Economic projections of Federal Reserve Board members and Federal Reserve Bank presidents, under their individual assessments of projected appropriate monetary policy, December 2016

Percent

Variable	Median[1]					Central tendency[2]					Range[3]				
	2016	2017	2018	2019	Longer run	2016	2017	2018	2019	Longer run	2016	2017	2018	2019	Longer run
Change in real GDP	1.9	2.1	2.0	1.9	1.8	1.8–1.9	1.9–2.3	1.8–2.2	1.8–2.0	1.8–2.0	1.8–2.0	1.7–2.4	1.7–2.3	1.5–2.2	1.6–2.2
September projection	1.8	2.0	2.0	1.8	1.8	1.7–1.9	1.9–2.2	1.8–2.1	1.7–2.0	1.7–2.0	1.7–2.0	1.6–2.5	1.5–2.3	1.6–2.2	1.6–2.2
Unemployment rate	4.7	4.5	4.5	4.5	4.8	4.7–4.8	4.5–4.6	4.3–4.7	4.3–4.8	4.7–5.0	4.7–4.8	4.4–4.7	4.2–4.7	4.1–4.8	4.5–5.0
September projection	4.8	4.6	4.5	4.6	4.8	4.7–4.9	4.5–4.7	4.4–4.7	4.4–4.8	4.7–5.0	4.7–4.9	4.4–4.8	4.3–4.9	4.2–5.0	4.5–5.0
PCE inflation	1.5	1.9	2.0	2.0	2.0	1.5	1.7–2.0	1.9–2.0	2.0–2.1	2.0	1.5–1.6	1.7–2.0	1.8–2.2	1.8–2.2	2.0
September projection	1.3	1.9	2.0	2.0	2.0	1.2–1.4	1.7–1.9	1.8–2.0	1.9–2.0	2.0	1.1–1.7	1.5–2.0	1.8–2.0	1.8–2.1	2.0
Core PCE inflation[4]	1.7	1.8	2.0	2.0		1.7–1.8	1.8–1.9	1.9–2.0	2.0		1.6–1.8	1.7–2.0	1.8–2.2	1.8–2.2	
September projection	1.7	1.8	2.0	2.0		1.6–1.8	1.7–1.9	1.9–2.0	2.0		1.5–2.0	1.6–2.0	1.8–2.0	1.8–2.1	
Memo: Projected appropriate policy path															
Federal funds rate	0.6	1.4	2.1	2.9	3.0	0.6	1.1–1.6	1.9–2.6	2.4–3.3	2.8–3.0	0.6	0.9–2.1	0.9–3.4	0.9–3.9	2.5–3.8
September projection	0.6	1.1	1.9	2.6	2.9	0.6–0.9	1.1–1.8	1.9–2.8	2.4–3.0	2.8–3.0	0.4–1.1	0.6–2.1	0.6–3.1	0.6–3.8	2.5–3.8

NOTE: Projections of change in real gross domestic product (GDP) and projections for both measures of inflation are percent changes from the fourth quarter of the previous year to the fourth quarter of the year indicated. PCE inflation and core PCE inflation are the percentage rates of change in, respectively, the price index for personal consumption expenditures (PCE) and the price index for PCE excluding food and energy. Projections for the unemployment rate are for the average civilian unemployment rate in the fourth quarter of the year indicated. Each participant's projections are based on his or her assessment of appropriate monetary policy. Longer-run projections represent each participant's assessment of the rate to which each variable would be expected to converge under appropriate monetary policy and in the absence of further shocks to the economy. The projections for the federal funds rate are the value of the midpoint of the projected appropriate target range for the federal funds rate or the projected appropriate target level for the federal funds rate at the end of the specified calendar year or over the longer run. The September projections were made in conjunction with the meeting of the Federal Open Market Committee on September 20–21, 2016. One participant did not submit longer-run projections for the change in real GDP, the unemployment rate, or the federal funds rate in conjunction with the September 20–21, 2016, meeting, and one participant did not submit such projections in conjunction with the December 13–14, 2016, meeting.

1. For each period, the median is the middle projection when the projections are arranged from lowest to highest. When the number of projections is even, the median is the average of the two middle projections.

2. The central tendency excludes the three highest and three lowest projections for each variable in each year.

3. The range for a variable in a given year includes all participants' projections, from lowest to highest, for that variable in that year.

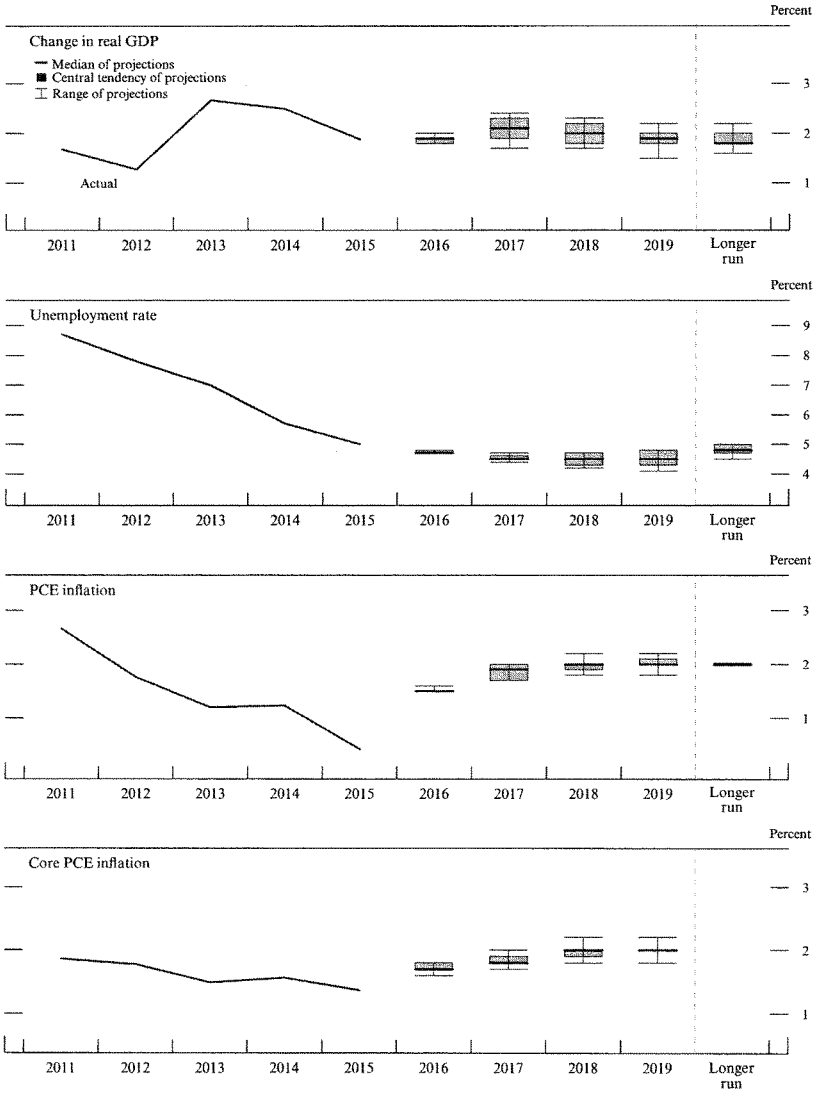
4. Longer-run projections for core PCE inflation are not collected.

The Outlook for Economic Activity

The median of participants' projections for the growth rate of real GDP, conditional on their individual assumptions about appropriate monetary policy, was 1.9 percent in 2016, 2.1 percent in 2017, 2.0 percent in 2018, and 1.9 percent in 2019; the median of projections for the longer-run normal rate of real GDP growth was 1.8 percent. Most participants projected that economic growth would pick up a bit in 2017 from the current year's pace and run at or slightly above their individual estimates of its longer-run rate through 2019. Compared with the September Summary of Economic Projections (SEP), the medians of the projections for real GDP growth were slightly higher over the period from 2017 to 2019, while the median assessment of the longer-run growth rate was unchanged. Since September, almost half of the participants revised up their projections for real GDP growth in 2018 or 2019, generally only slightly. Those increasing their projections for output growth in those years cited expected changes in fiscal, regulatory, or other policies as factors contributing to their revisions. However, many participants noted that the effects on the economy of such policy changes, if implemented, would likely be partially offset by tighter financial conditions, including higher longer-term interest rates and a strengthening of the dollar.

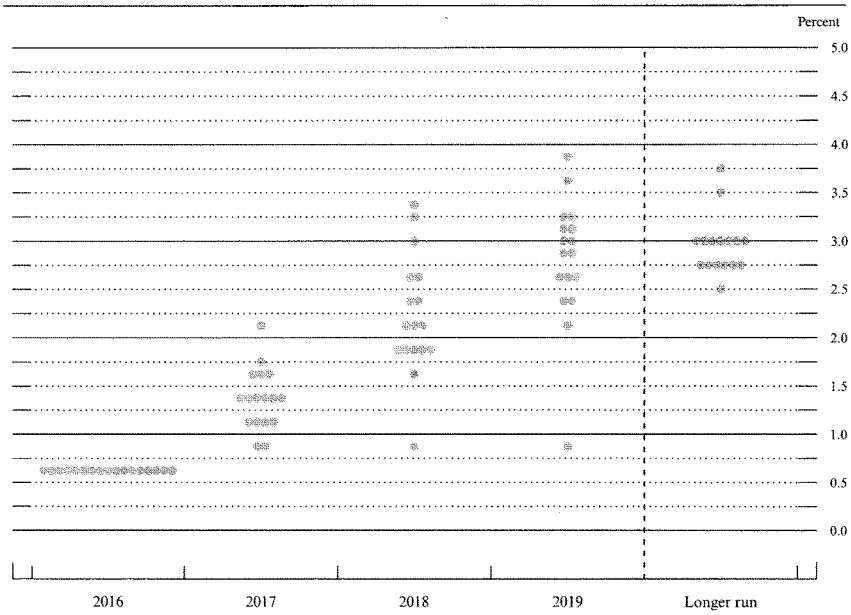
The median of projections for the unemployment rate in the fourth quarter of 2016 was 4.7 percent, slightly lower than in September. Based on the median projections, the anticipated path of the unemployment rate for coming years also shifted down a bit, with the median for the end of 2019 at 4.5 percent, 0.3 percentage point below the median assessment of the longer-run normal rate of unemployment, which was unchanged from September.

Figure 1. Medians, central tendencies, and ranges of economic projections, 2016–19 and over the longer run



NOTE: Definitions of variables and other explanations are in the notes to table 1. The data for the actual values of the variables are annual.

Figure 2. FOMC participants' assessments of appropriate monetary policy: Midpoint of target range or target level for the federal funds rate



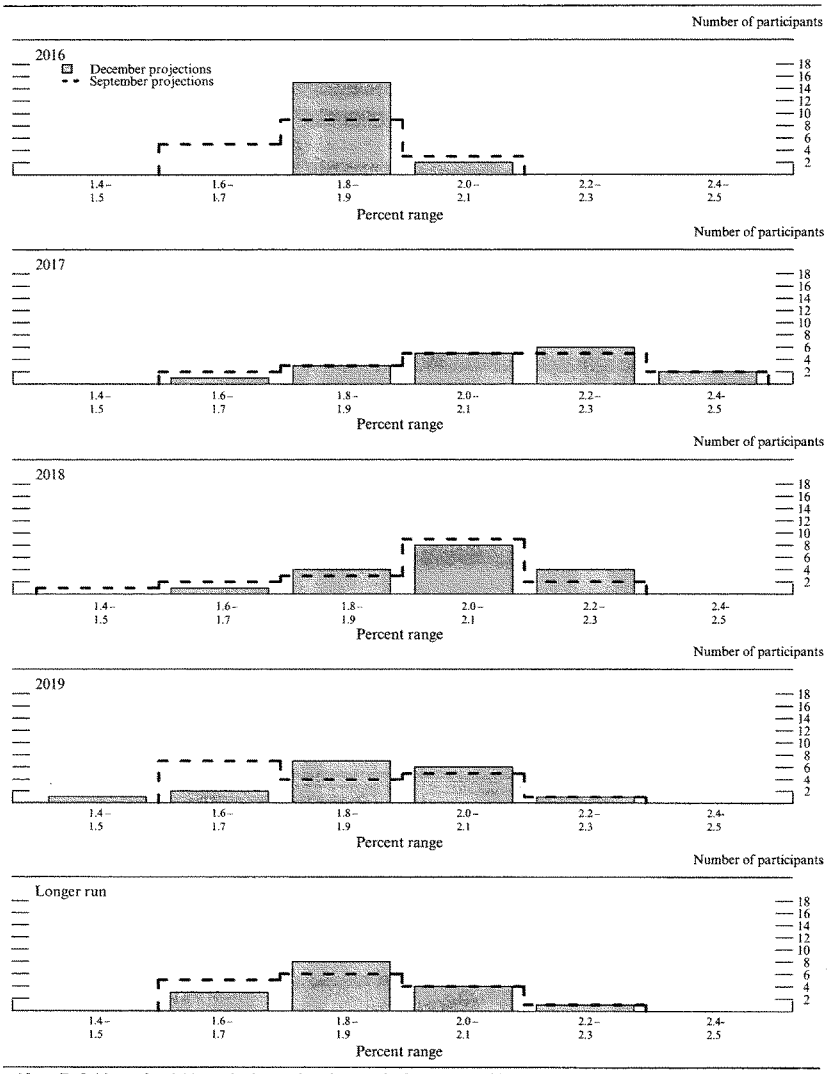
NOTE: Each shaded circle indicates the value (rounded to the nearest ¼ percentage point) of an individual participant's judgment of the midpoint of the appropriate target range for the federal funds rate or the appropriate target level for the federal funds rate at the end of the specified calendar year or over the longer run. One participant did not submit longer-run projections for the federal funds rate.

Figures 3.A and 3.B show the distributions of participants' projections for real GDP growth and the unemployment rate from 2016 to 2019 and in the longer run. The distributions of individual projections of real GDP growth shifted slightly higher relative to the distribution of the September projections for 2017 through 2019. The distributions of projections for the unemployment rate shifted modestly lower for 2016 through 2019, while the distribution of projections for the longer-run normal rate of unemployment was unchanged.

The Outlook for Inflation

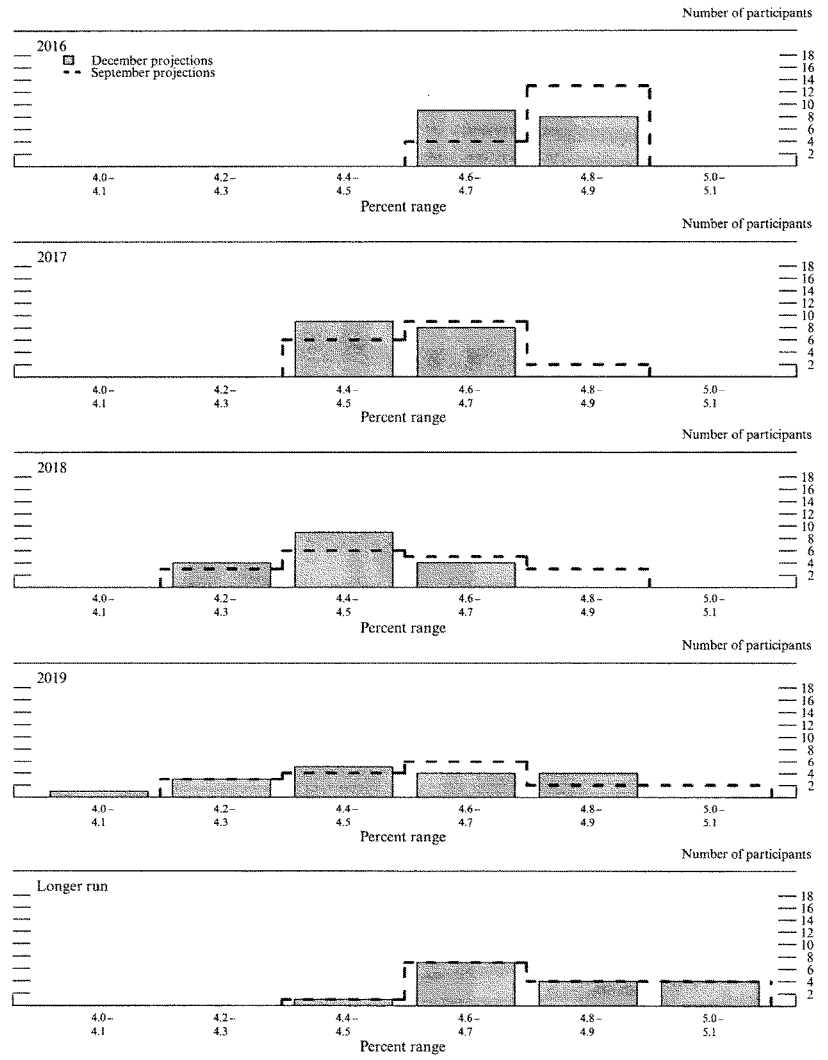
In the December SEP, the median of projections for headline PCE price inflation in 2016 was 1.5 percent, a bit higher than in September. The median of projections for headline PCE price inflation was 1.9 percent in 2017 and 2.0 percent in 2018 and 2019, unchanged from September. Several participants projected that inflation will slightly exceed the Committee's objective in 2018 or 2019. The medians of projections for core PCE price inflation were the same as in September, rising from 1.7 percent in 2016 to 1.8 percent in 2017 and 2.0 percent in 2018 and 2019.

Figure 3.A. Distribution of participants' projections for the change in real GDP, 2016–19 and over the longer run



NOTE: Definitions of variables and other explanations are in the notes to table 1.

Figure 3.B. Distribution of participants' projections for the unemployment rate, 2016–19 and over the longer run



NOTE: Definitions of variables and other explanations are in the notes to table 1.

Figures 3.C and 3.D provide information on the distribution of participants' views about the outlook for inflation. The distributions of projections for headline and core PCE price inflation shifted up slightly relative to projections for the September meeting. Some participants attributed the upward shift in projected inflation this year and next to recent data that showed somewhat higher inflation than they had expected. A few saw higher inflation in 2019 in conjunction with somewhat greater undershooting of the unemployment rate below its longer-run normal level.

Appropriate Monetary Policy

Figure 3.E provides the distribution of participants' judgments regarding the appropriate target for the federal funds rate at the end of each year from 2016 to 2019 and over the longer run.[7] All participants saw an increase of 25 basis points in the federal funds rate at the December meeting as appropriate. The distributions for 2017 through 2019 shifted up modestly. The median projections of the federal funds rate continued to show gradual increases, to 1.4 percent at the end of 2017, 2.1 percent at the end of 2018, and 2.9 percent at the end of 2019; the median of the longer-run projections of the federal funds rate was 3.0 percent. The medians of the projections for the level of the federal funds rate for 2017 through 2019 were all 25 basis points higher than in the September projections. A few participants revised up their assessments of the longer-run federal funds rate 25 basis points, resulting in an increase in the median of 13 basis points.

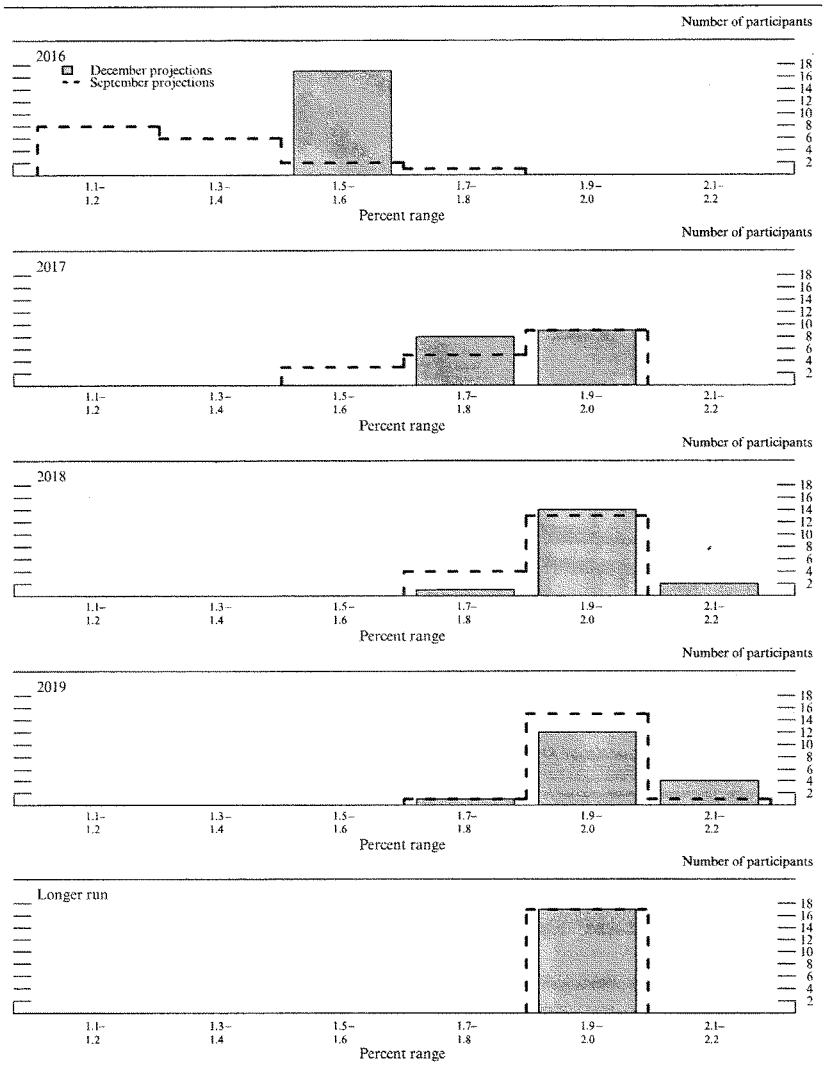
In discussing their December forecasts, many participants expressed a view that increases in the federal funds rate over the next few years would likely be gradual in light of a short-term neutral real interest rate that currently was low—a phenomenon that a number of participants attributed to the persistence of low productivity growth, continued strength of the dollar, a weak outlook for economic growth abroad, strong demand for safe longer-term assets, or other factors—and that was likely to rise only slowly as the effects of these factors faded over time. Some participants noted the continued proximity of short-term nominal interest rates to the effective lower bound, even with an increase at this meeting, as limiting the Committee's ability to increase monetary accommodation to counter possible adverse shocks to the economy. These participants judged that, as a result, the Committee should take a cautious approach to removing policy accommodation. Many participants noted that there was currently substantial uncertainty about the size, composition, and timing of prospective fiscal policy changes, but they also commented that a more expansionary fiscal policy might raise aggregate demand above sustainable levels, potentially necessitating somewhat tighter monetary policy than currently anticipated. Furthermore, several participants indicated that recent inflation data and the continued strengthening in labor market conditions increased their confidence that inflation would move toward the 2 percent objective, making a slightly firmer path of monetary policy appropriate.

Uncertainty and Risks

The left-hand column of figure 4 shows that, for each variable, a majority of participants judged the levels of uncertainty associated with their December projections for real GDP growth, the unemployment rate, headline

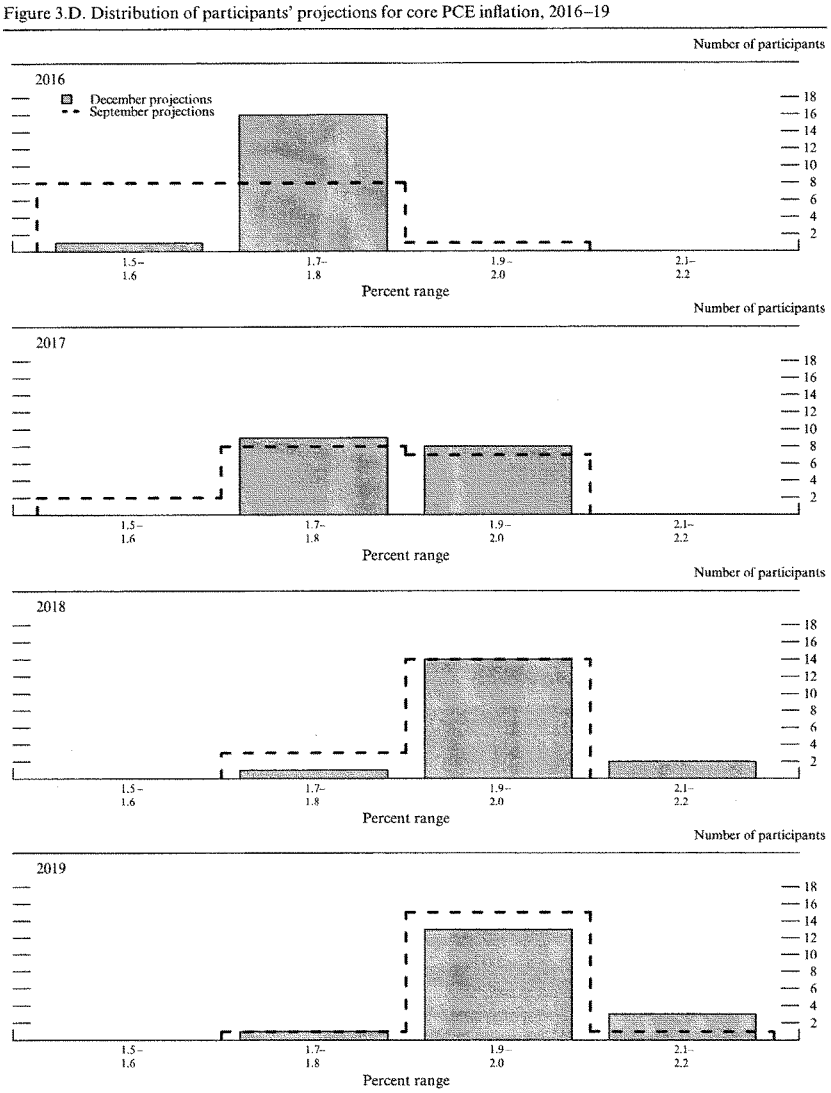
7. One participant's projections for the federal funds rate, real GDP growth, the unemployment rate, and inflation were informed by the view that there are multiple possible medium-term regimes for the U.S. economy, that these regimes are persistent, and that the economy shifts between regimes in a way that cannot be forecast. Under this view, the economy currently is in a regime characterized by expansion of economic activity with low productivity growth and a low short-term real interest rate, but longer-term outcomes for variables other than inflation cannot be usefully projected.

Figure 3.C. Distribution of participants' projections for PCE inflation, 2016–19 and over the longer run



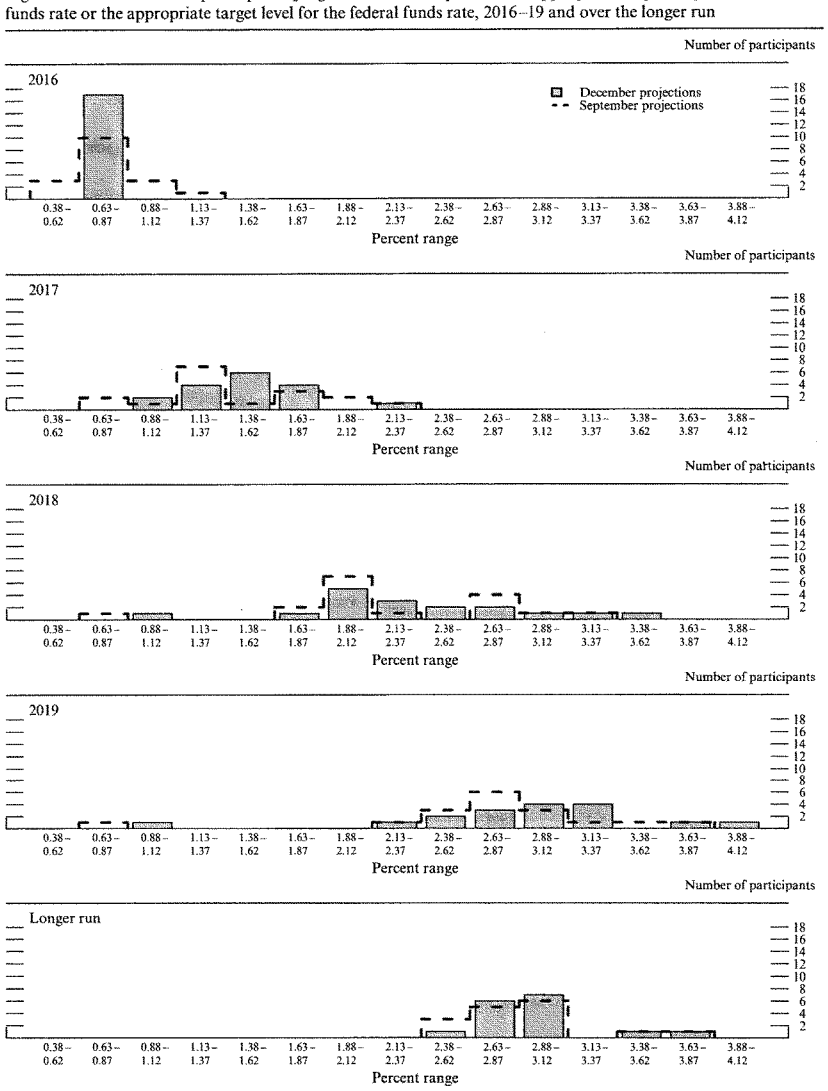
NOTE: Definitions of variables and other explanations are in the notes to table 1.

Figure 3.D. Distribution of participants' projections for core PCE inflation, 2016–19



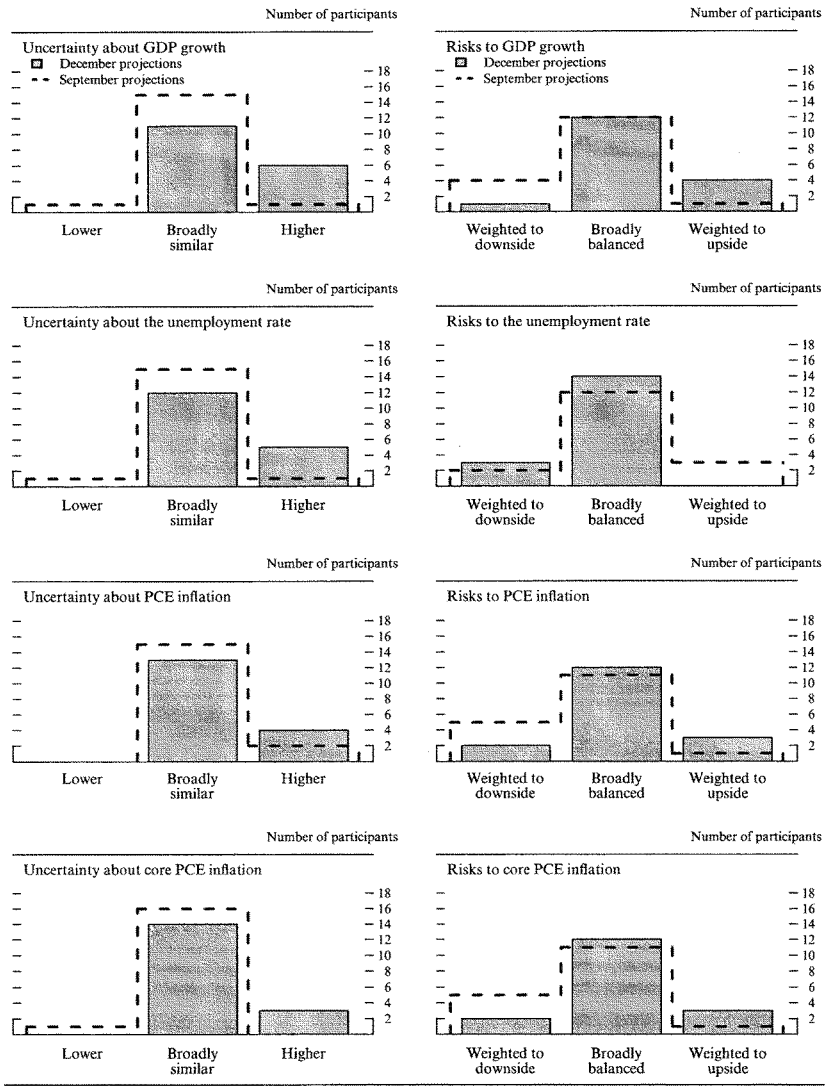
NOTE: Definitions of variables and other explanations are in the notes to table 1.

Figure 3.E. Distribution of participants' judgments of the midpoint of the appropriate target range for the federal funds rate or the appropriate target level for the federal funds rate, 2016–19 and over the longer run



NOTE: Definitions of variables and other explanations are in the notes to table 1.

Figure 4. Uncertainty and risks in economic projections



NOTE: For definitions of uncertainty and risks in economic projections, see the box "Forecast Uncertainty." Definitions of variables are in the notes to table 1.

inflation, and core inflation to be broadly similar to the average of the past 20 years.[8] However, more participants than in September saw uncertainty surrounding real GDP growth, the unemployment rate, or inflation as higher than average. Many participants mentioned an increase in uncertainty associated with fiscal, trade, immigration, or regulatory policies as a factor influencing their judgments about the degree of uncertainty surrounding their projections. Participants cited the difficulty of predicting the size, composition, and timing of these policy changes as well as the magnitude and timing of their effects on the economy.

As can be seen in the right-hand column of figure 4, a majority of participants continued to see the risks to real GDP growth, the unemployment rate, headline inflation, and core inflation as broadly balanced; however, fewer participants saw risks to economic growth and inflation as weighted to the downside or saw risks to the unemployment rate as weighted to the upside than in September. A number of participants noted that the prospect of expansionary fiscal policy had increased the upside risks to economic activity and inflation, and a few assessed the possibility of a reduction in regulation as posing upside risks to their forecasts of economic activity. Moreover, some participants judged that the recent rise in market-based measures of inflation compensation suggested that downside risks to inflation had declined. However, many also pointed to various sources of downside risk to economic activity, such as the limited potential for monetary policy to respond to adverse shocks when the federal funds rate is near the effective lower bound, downside risks in Europe and China, a possible increase in trade barriers, and the possibility of a sharp rise in financial market volatility in the event that fiscal and other policy changes diverged from market expectations. In addition, some participants pointed to factors such as global disinflationary trends and downward pressure on import prices from further strengthening of the dollar as sources of downside risk to inflation.

Table 2. Average historical projection error ranges

Percentage points

Variable	2016	2017	2018	2019
Change in real GDP[1]	±0.9	±1.7	±2.1	±2.1
Unemployment rate[1]	±0.1	±0.8	±1.4	±1.9
Total consumer prices[2]	±0.2	±1.0	±1.1	±1.1

Note: Error ranges shown are measured as plus or minus the root mean squared error of projections for 1996 through 2015 that were released in the winter by various private and government forecasters. (The note to this table that was included in the Summary of Economic Projections for the meeting of September 20–21, 2016, incorrectly stated that the error ranges were based on projections for 1995 through 2015. The correct time period was 1996 through 2015.) As described in the box "Forecast Uncertainty," under certain assumptions, there is about a 70 percent probability that actual outcomes for real GDP, unemployment, and consumer prices will be in ranges implied by the average size of projection errors made in the past. For more information, see David Reifschneider and Peter Tulip (2007), "Gauging the Uncertainty of the Economic Outlook from Historical Forecasting Errors," Finance and Economics Discussion Series 2007-60 (Washington: Board of Governors of the Federal Reserve System, November), available at www.federalreserve.gov/pubs/feds/2007/200760/0760abs.html; and Board of Governors of the Federal Reserve System, Division of Research and Statistics (2014), "Updated Historical Forecast Errors," memorandum, April 9, www.federalreserve.gov/foia/files/20140409-historical-forecast-errors.pdf.

1. Definitions of variables are in the general note to table 1.

2. Measure is the overall consumer price index, the price measure that has been most widely used in government and private economic forecasts. Projection is percent change, fourth quarter of the previous year to the fourth quarter of the year indicated.

8. Table 2 provides estimates of the forecast uncertainty for the change in real GDP, the unemployment rate, and total consumer price inflation over the period from 1996 through 2015. At the end of this summary, the box "Forecast Uncertainty" discusses the sources and interpretation of uncertainty in the economic forecasts and explains the approach used to assess the uncertainty and risks attending the participants' projections.

Forecast Uncertainty

The economic projections provided by the members of the Board of Governors and the presidents of the Federal Reserve Banks inform discussions of monetary policy among policymakers and can aid public understanding of the basis for policy actions. Considerable uncertainty attends these projections, however. The economic and statistical models and relationships used to help produce economic forecasts are necessarily imperfect descriptions of the real world, and the future path of the economy can be affected by myriad unforeseen developments and events. Thus, in setting the stance of monetary policy, participants consider not only what appears to be the most likely economic outcome as embodied in their projections, but also the range of alternative possibilities, the likelihood of their occurring, and the potential costs to the economy should they occur.

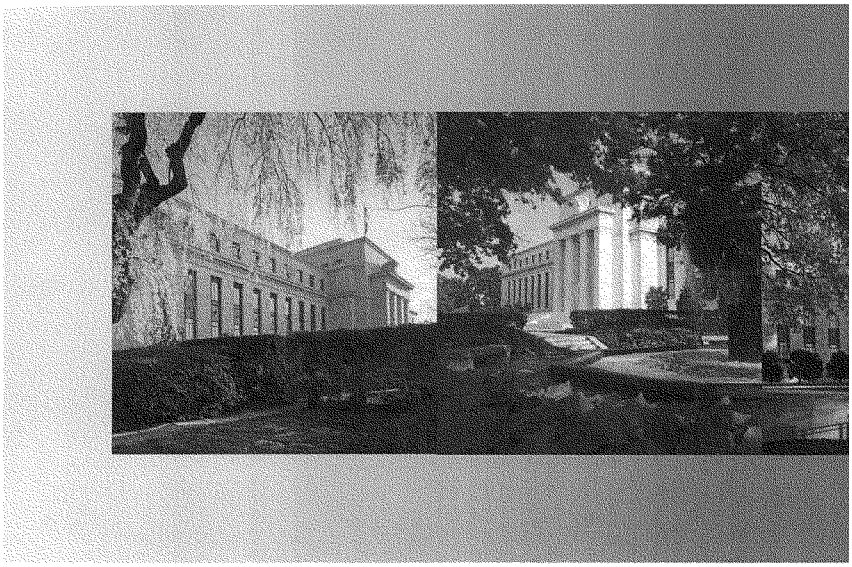
Table 2 summarizes the average historical accuracy of a range of forecasts, including those reported in past *Monetary Policy Reports* and those prepared by the Federal Reserve Board's staff in advance of meetings of the Federal Open Market Committee. The projection error ranges shown in the table illustrate the considerable uncertainty associated with economic forecasts. For example, suppose a participant projects that real gross domestic product (GDP) and total consumer prices will rise steadily at annual rates of, respectively, 3 percent and 2 percent. If the uncertainty attending those projections is similar to that experienced in the past and the risks around the projections are broadly balanced, the numbers reported in table 2 would imply a probability of about 70 percent that actual GDP would expand within a range of 2.1 to 3.9 percent in the current year, 1.3 to 4.7 percent in the second year, and 0.9 to 5.1 percent in the third and fourth years. The corresponding 70 percent confidence intervals for overall inflation would be 1.8 to 2.2 percent in the current year, 1.0 to 3.0 in the second year, and 0.9 to 3.1 percent in the third and fourth years.

Because current conditions may differ from those that prevailed, on average, over history, participants provide judgments as to whether the uncertainty attached to their projections of each variable is greater than, smaller than, or broadly similar to typical levels of forecast uncertainty in the past, as shown in table 2. Participants also provide judgments as to whether the risks to their projections are weighted to the upside, are weighted to the downside, or are broadly balanced. That is, participants judge whether each variable is more likely to be above or below their projections of the most likely outcome. These judgments about the uncertainty and the risks attending each participant's projections are distinct from the diversity of participants' views about the most likely outcomes. Forecast uncertainty is concerned with the risks associated with a particular projection rather than with divergences across a number of different projections.

As with real activity and inflation, the outlook for the future path of the federal funds rate is subject to considerable uncertainty. This uncertainty arises primarily because each participant's assessment of the appropriate stance of monetary policy depends importantly on the evolution of real activity and inflation over time. If economic conditions evolve in an unexpected manner, then assessments of the appropriate setting of the federal funds rate would change from that point forward.

Abbreviations

AFE	advanced foreign economy
BLS	Bureau of Labor Statistics
DPI	disposable personal income
EME	emerging market economy
FOMC	Federal Open Market Committee; also, the Committee
GDP	gross domestic product
JOLTS	Job Openings and Labor Turnover Survey
LIBOR	London interbank offered rate
MBS	mortgage-backed securities
Michigan survey	University of Michigan Surveys of Consumers
MMF	money market mutual fund
OIS	overnight index swap
ON RRP	overnight reverse repurchase agreement
OPEC	Organization of the Petroleum Exporting Countries
PCE	personal consumption expenditures
SEP	Summary of Economic Projections
SLOOS	Senior Loan Officer Opinion Survey on Bank Lending Practices
SOMA	System Open Market Account
S&P	Standard & Poor's
TIPS	Treasury Inflation-Protected Securities



Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Representative Emmer:

1. In addition to monetary policy, the Federal Reserve also plays an important role regulating and supervising the financial industry. As part of those activities, the Federal Reserve has "gold plated" international capital regulations, specifically the Supplementary Leverage Ratio or SLR.

In February 2016 when you testified before this committee you were asked about the SLR, its effect specifically on custody banks, and the harm a higher SLR for custody banks might create for pension funds, mutual funds, and the financial system as a whole. At that point you said that the SLR was a "crude" tool and you were looking into the concerns raised about the rule's application to custody banks.

I appreciated your answer last year as well as Federal Reserve Governor Dan Tarullo's statement in December on making changes to capital standards that would reflect custody bank's needs to provide services to their clients. In December, Governor Tarullo specifically said that, "as part of our efforts to tailor our regulations according to the business models of firms, we are considering ways to address the special issues posed for the large custody banks by certain elements of our regulatory framework."

In light of that statement, can you provide some more details on what steps the Federal Reserve is taking to tailor regulations to the custody bank business model, and when we will see those reforms rolled out?

By its very nature, the Supplementary Leverage Ratio (SLR) does not differentiate among asset classes according to the level of risk they pose. The purpose of the SLR is to be a simple complement to the more complex risk-based capital ratios, such that each offsets the potential weaknesses of the other. The total leverage exposure measure, which is the denominator of the SLR, includes all assets reported on the balance sheet and certain off-balance sheet items, regardless of the risk associated with individual exposures. This includes certain very low-risk exposures, such as deposits with the Federal Reserve, which is a common asset of custody banks.

Some custody banks have raised concerns regarding the potential unintended consequences associated with the enhanced SLR standard. The enhanced SLR (which applies only to the largest, most systemically important U.S. banking organizations) is calculated in the same manner as the SLR (which applies to all advanced approaches U.S. banking organizations). However, the enhanced SLR is calibrated at a higher level (i.e., five percent for bank holding companies). A specific concern raised by the custody banks is the relatively high capital requirement that the enhanced SLR standard imposes on the large volume of deposits that custody banks place with the Federal Reserve as they reinvest their clients' excess cash.

The Federal Reserve Board (Board) has had an ongoing dialogue with the custody banks about potential ways to address their concerns about the calibration of the enhanced SLR and welcomes continued engagement. The Board is actively considering ways to address the concerns raised by the custody banks and other market participants about the leverage ratio

framework, including the calibration of the enhanced SLR. Before making any changes to its rules, including those relating to the SLR and enhanced SLR, the Board would provide notice and invite public comment.

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Representative Emmer:

2. In one of your previous appearances before this committee, I asked you about the impact that raising the Fed Funds rate could have on farmers and agriculture affiliated businesses. You mentioned that the Fed has studied this impact, however, given the very pessimistic outlooks for our farm economy and the continued strength of the U.S. dollar, I am interested to see if the Fed has revisited and reexamined this issue at all?

In the time since our earlier exchange on this topic, the financial situation has not changed greatly. The Federal Open Market Committee (FOMC) increased the target range for the federal funds rate by 25 basis points in late 2015--right around the time of our earlier exchange; by another 25 basis points in late 2016; and by a third increment of 25 basis points at its meeting in March of this year. The current target range--which extends from ¾ percent to 1 percent--is still low by historical standards. As of early 2016, when I last wrote to you, I noted that the FOMC was anticipating "modest increases in interest rates," and that has certainly been the outcome in terms of the policy rates that we set.

In agriculture, bank lending rates have also increased by about 70 basis points on average since late 2015. Although farmers' interest expenses are anticipated to be about 12 percent higher in 2017 than in 2015, interest expenses on farm debt still account for less than 6 percent of total farm sector expenses.

With regard to the effects of the dollar, the foreign exchange value of the dollar has increased only modestly since late 2015, and the value of U.S. agricultural exports have actually increased by about 5 percent over the past year compared with the prior 12 months. However, U.S. agricultural commodity prices have generally remained suppressed since 2015, reflecting several consecutive years of strong production. Some farmers have faced greater financial pressure in this environment, but on average farm loan delinquencies remain at historically low levels.

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Representative Emmer:

3. Can you give the Committee some insights on the current positioning of the Fed's balance sheet and thinking on retention at current levels and the potential for reducing holdings?

As noted in recent Federal Open Market Committee (FOMC) statements, the Committee has indicated that it expects to continue its current policy of reinvestments until the process of normalizing the level of the federal funds rate is well underway. However, the Committee has not established a formal linkage between a particular level of the federal funds rate and a change in its reinvestment policy.

The FOMC conducts monetary policy to promote its longer-term objectives of maximum employment and stable prices. Consistent with this overarching principle, the FOMC will reach a judgment about reinvestments and the balance sheet based on its assessment of the economic outlook and the prospects for continued progress toward its longer run objectives. This process will include an evaluation of the anticipated trajectory for the economy as well as the risks to the economic outlook.

As noted in the minutes of the March 2017 FOMC meeting, provided that the economy continued to perform about as expected, most participants anticipated that gradual increases in the federal funds rate would continue and judged that a change to the Committee's reinvestment policy would likely be appropriate later this year.

As noted in the FOMC's statement of Policy Normalization Principles and Plans, the Committee intends that the Federal Reserve will, in the longer run, hold no more securities than necessary to implement monetary policy efficiently and effectively. Moreover, in the longer run, the FOMC intends to hold primarily Treasury securities. As always, the Committee is prepared to adjust the details of its approach to policy normalization in light of economic and financial developments.

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Representative Hill:

1. In response to Mr. Williams question regarding what is currently stopping the Federal Reserve from winding down its balance sheet, you stated that the federal funds rate range was now between 50 and 75 basis points and that you wanted "a bit more buffer" in order to reach normalization so that the Fed could then begin to contract the size of its balance sheet.

What range constitutes "a bit more buffer"? In other words, specifically at what range does the federal funds rate need to reach for the Fed to start running off its balance sheet?

As noted in recent Federal Open Market Committee (FOMC) statements, the Committee has indicated that it expects to continue its current policy of reinvestments until the process of normalizing the level of the federal funds rate is well underway. However, the Committee has not established a formal linkage between a particular level of the federal funds rate and a change in its reinvestment policy.

The FOMC conducts monetary policy to promote its longer-term objectives of maximum employment and stable prices. Consistent with this overarching principle, the FOMC will reach a judgment about reinvestments and the balance sheet based on its assessment of the economic outlook and the prospects for continued progress toward its longer run objectives. This process will include an evaluation of the anticipated trajectory for the economy as well as the risks to the economic outlook.

As noted in the minutes of the March 2017 FOMC meeting, provided that the economy continued to perform about as expected, most participants anticipated that gradual increases in the federal funds rate would continue and judged that a change to the Committee's reinvestment policy would likely be appropriate later this year.

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Representative Hultgren:

1. The Financial Crimes Enforcement Network ("FinCEN") recently exempted banks from its new Customer Due Diligence Rule for accounts established to finance insurance premiums, where loan proceeds are remitted directly by the bank to an insurer. FinCEN agreed with the industry "that these types of accounts present a low risk of laundering" and represent a "poor vehicle" for money laundering.

Despite FinCEN's finding of negligible Anti-Money Laundering ("AML") risk, the Federal Reserve Board has been requiring banks to apply another AML measure, customer identification programs ("CIP"), to premium financing accounts. This may put bank-affiliated lenders at a competitive disadvantage with non-bank companies, which are not obligated to apply such programs, and could be driving bank-affiliated premium insurance business out of the market. This would in turn make it more difficult for small businesses and others that rely on this kind of lending.

a. Will the Federal Reserve confirm that it will work with FinCEN and the bank-owned premium finance industry to also exclude it from CIP requirements, making use of exemptive authority as needed? Absent such confirmation, please explain the rationale, if any, for not using these agencies' exemptive authority or other authority to exclude bank-owned premium finance lenders from CIP requirements.

b. If the Federal Reserve sees risk in certain sectors of the premium finance industry, are there specific types of premium finance, for example with respect to property and casualty insurance that might be fully or partly exempted?

Yes, the Board of Governors of the Federal Reserve System (Board) will work with Treasury's Financial Crimes Enforcement Network (FinCEN), the other Federal Banking Agencies (FBAs),[1] and bank-affiliated premium finance lenders to consider requests to exempt bank-affiliated premium finance lenders and insurance premium finance accounts from the interagency Customer Identification Program (CIP) rule.[2]

FinCEN's Customer Due Diligence (CDD) rule was adopted in 2016[3] and generally requires a covered financial institution, which includes FBA-supervised banks, to identify and verify the beneficial owner of legal entity accountholders.[4] The CDD rule explicitly exempts covered financial institutions from this requirement with respect to accounts that "[f]inance insurance premiums and for which payments are remitted directly by the financial institution to the insurance provider or broker."[5] The CDD rule does not exempt insurance premium finance accounts from the CIP rule and other anti-money laundering requirements.

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[1] The FBAs include the Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the National Credit Union Association.
[2] "Banks" for the purposes of this response is consistent with the definition at 31 CFR 1020.100(b).
[3] 81 FR 29397 (May 11, 2016).
[4] 31 CFR 1010.230(a) and 1020.210(b)(5)(ii).
[5] 31 CFR § 1010.230(h)(1)(iii).

In contrast to the CDD rule, the CIP rule was jointly adopted by Treasury, the Board, and other FBAs in 2003. The CIP rule in coordination with guidance requires banks and their domestic subsidiaries, other than functionally regulated subsidiaries, to establish risk-based procedures for verifying the identity of their customers when opening an account within the meaning of the regulation.[6] The CIP requirements apply to extensions of credit, including insurance premium finance accounts.[7] The specific minimum requirements in the CIP rule allow the bank to establish a reasonable belief that it knows each customer's identity and can be satisfied by obtaining basic information before opening the account, such as the customer's name, date of birth for individuals, address, and an identification number.

The CIP rule provides that the Board and other FBAs may exempt any FBA-supervised bank or type of account from CIP requirements with the concurrence of the Secretary of the Treasury (Secretary).[8] The CIP rule also provides the Secretary with sole authority to exempt banks and accounts that are not supervised by an FBA from CIP requirements. To exercise this authority, the FBA and the Secretary must consider whether the exemption is consistent with the purposes of the Bank Secrecy Act and with safe and sound banking. The FBA and the Secretary may also consider "other appropriate factors."

Banks of all charter types may offer insurance premium finance accounts. The Board will therefore work with the other FBAs and Treasury not only to determine whether to exempt bank-affiliated premium finance lenders and insurance premium finance accounts from CIP requirements, but also to establish a process for coordinating reviews of CIP exemption requests.

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[6] The CIP requirements for banks are specified at 31 CFR §1020.220.

[7] 31 CFR 1020.100(a)(1) (defining "account" to include "a credit account, or other extension of credit").

[8] 31 CFR 1020.220(b). The CIP rule's exemption authority implements a provision of the Bank Secrecy Act that allows a Federal functional regulator, with the concurrence of the Secretary, to "exempt any financial institution or type of account from [CIP] requirements . . . in accordance with such standards and procedures as the Secretary may prescribe." 31 U.S.C. § 5318(l)(5). The CIP rule also provides exemption authority to the Securities and Exchange Commission and the Commodity Futures Trading Commission, with the concurrence of the Secretary, to exempt broker-dealers, mutual funds, futures commission merchants and introducing brokers in commodities from CIP requirements.

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Representative Hultgren:

2. An April 2016 GAO report found that the Fed "should revise the resolution plan rule's annual filing requirements to provide sufficient time not only for the regulators to complete their plan reviews and provide feedback but also for companies to address and incorporate regulators' feedback in subsequent plan filings." It suggests extending the annual filing cycle to every 2 years.

a. Does the Fed plan to adjust its living wills filing cycle to be in line with the GAO's recommendation? If so, when?

b. If not, why does the Fed disagree with the recommendations of the Government Accountability Office?

The Federal Reserve supports the Government Accountability Office's (GAO) recommendation to lengthen the current one-year resolution plan filing cycle and is consulting with the Federal Deposit Insurance Corporation (FDIC) on potential revisions to the regulation requiring annual resolution plan submissions. The Federal Reserve also has taken a number of actions since the GAO report to extend filing deadlines and reduce reporting requirements of resolution plan filers. In April 2016, the Federal Reserve and the FDIC (agencies) permitted domestic global systemically important banks to provide a progress report in October 2016 on their efforts to address shortcoming and deficiencies identified by the agencies in lieu of a full resolution plan due in July 2016. In June 2016, the agencies permitted 84 firms with limited U.S. operations to file resolution plans with significantly reduced informational content for three years. In August 2016, the agencies extended the deadline from year-end 2016 to year-end 2017 for the resolution plan submissions of certain smaller firms and non-bank organizations. In March 2017, the agencies granted certain large foreign banking organizations a one-year extension to incorporate guidance provided by the agencies for their next plans.

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Representative Hultgren:

3. This month, a report was published by Harvard University paper titled *The Financial Regulatory Reform Agenda in 2017* by Robin Greenwood, Samuel G. Hanson, Adi Sunderam, and former Federal Reserve Governor Jeremy C. Stein that makes some criticism of the Supplementary Leverage Ratio.[1] The paper states, "The problem with the current implementation of the SLR, however, is that it has been calibrated too aggressively. As a result, it has distorted risk choices, discouraging some banks from investing in the safest assets. These distortions have already had an adverse effect on the functioning of the Treasury market. We would urge that the SLR be dialed back, so that it serves only as a secondary backup to the risk-based capital regime, and is not among the primary regulatory constraints that banks face."

I was encouraged when I saw remarks from Governor Tarullo last December stating, "And as part of our efforts to tailor our regulations according to the business models of firms, we are considering ways to address the special issues posed for the large custody banks by certain elements of our regulatory framework."[2]

a. Does the Federal Reserve Board plan to tailor the Supplementary Leverage Ratio (SLR) to acknowledge that deposits at the Fed are low-risk off-balance sheet exposures? In other words, can we expect these deposits will be removed from the calculation of the SLR?

The total leverage exposure measure, which is the denominator of the Supplementary Leverage Ratio (SLR), includes all assets reported on the balance sheet and certain off-balance sheet items, regardless of the risk associated with individual exposures. The custody banks have raised concerns regarding the relatively high capital requirement that the enhanced SLR standard imposes on the large volume of deposits that they place with the Federal Reserve as they reinvest their clients' excess cash. The Federal Reserve has engaged in discussions with the firms on potential ways to address their concerns and welcomes continued engagement.

The custody banks have suggested several potential reforms of the enhanced SLR to address their concerns, including an exclusion of some or all central bank deposits from the denominator of the SLR and a recalibration of the enhanced SLR so that each of our most systemic banking firms would face an enhanced SLR that is proportional to its individual systemic footprint. The Federal Reserve Board (Board) is actively considering these suggestions and other suggestions from market participants about how to improve the cost-benefit balance of our leverage ratio requirements.

b. If so, will this be done via rulemaking? When will the Fed (and other banking regulators) propose a rule change?

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[1] Greenwood, R., Hanson, S. G., Stein, J. C., & Sunderam, A. (2017). The Financial Regulatory Reform Agenda in 2017. *Harvard University.*

[2] Federal Reserve Board Governor Daniel K Tarullo. Federal Reserve Bank of Cleveland and Office of Financial Research Financial Stability Conference. December 2, 2016. Note: Governor Tarullo recently announced he will retire soon. https://www.federalreserve.gov/newsevents/speech/tarullo20161202a.htm.

The Board is actively considering ways to address the concerns raised by custody banks and other members of the public about the Federal Reserve's leverage ratio framework. Before making any changes to its rules, including those relating to the SLR, the Board would provide notice and invite public comment.

4. I want to follow-up on the answers you provided to my Questions for the Record regarding the treatment of segregated customer margin in the U.S. implementation of the Basel leverage ratios for your last appearance before the House Committee on Financial Services. You answered a fundamentally different question on the treatment of on-balance sheet cash in the denominator of leverage ratio calculation rather than address my question on the exposure reducing effect of segregated customer margin for off-balance sheet exposures.

You noted that the Supplementary Leverage Ratio ("SLR") "requires a banking organization to hold a minimum amount of capital against on balance sheet assets and off-balance sheet exposures, including with respect to segregated customer margin, regardless of the risk associated with the individual exposure." I was not disputing this application or the purpose of the SLR. This is not a question of "excluding select categories of on-balance sheet assets" as discussed in your response. Therefore, I would like to clarify the question.

a. Why is segregated customer margin for cleared derivatives not recognized as reducing the off-balance sheet exposure you mention? By its very nature, the customer margin received and segregated by a bank-affiliated clearing agent reduces the bank's exposure to guarantee the debt owed by its customers to the clearinghouse.

The SLR rule requires internationally active banking organizations to hold a minimum amount of capital against both on-balance sheet assets as determined under U.S. accounting standards and certain off-balance sheet exposures specified in the rule, regardless of the risk associated with the individual exposure.

A fundamental construction principle of the SLR – and other leverage ratios – is to impose the same capital requirement on each of a bank's exposures, regardless of the creditworthiness of the counterparty and regardless of the presence of credit risk mitigants such as collateral. Accordingly, the current SLR does not recognize customer margin despite its economic value in reducing a bank's credit risk. The Board continues to explore, however, alternative methods for measuring the potential future exposure of derivatives for purposes of the SLR and continues to assess the overall calibration of the enhanced SLR that it applies to the U.S. global systemically important banks (GSIBs).

5. I am also not certain you understood the intention of my second question concerning the U.S. implementation of the Basel leverage ratios. You responded to my question suggesting that fewer bank-affiliated clearing firms will continue this line of business by stating, "the swap margin rule, issued in October 2015, incentivized firms to clear through central counterparties."

I am not disputing that clearing via central counterparties is increasingly required and/or "incentivized" by various regulations. As increased clearing takes hold, I am concerned that agents tasked with fulfilling the very rule you mention – those who act as

intermediaries between the firms now "incentivized to clear" and the central counterparty – will find it increasingly unappealing to continue this service.

a. How will the new clearing requirements coming into effect be impacted as consolidation among those who guarantee customer clearing obligations with the central counterparty (sometimes bank-affiliated clearing members) exit the business or reduce such services available to customers? These are customers who now more than ever need access to central clearing.

Achieving the full intended benefits of the move of standardized derivatives to central clearing does require that we have a substantial set of dealers that are willing and able to intermediate derivatives between end users and the central counterparties. Although a few dealers have exited or substantially reduced their client clearing businesses over the past few years – for a variety of different reasons – a substantial number of dealers remain active in client clearing. The Board will continue to monitor developments in this area and will coordinate with other policy makers to maximize the net systemic risk benefits from the move of standardized derivatives to central clearing.

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Representative Loudermilk:

1. As you know, Congress has conducted oversight into reports of more than 50 cyber breaches that took place at the Federal Reserve between 2011 and 2015.[1] I understand that the Federal Reserve's cybersecurity efforts to protect sensitive data, including consumers' personally identifiable information (PII), are ongoing.

a. What are the most pressing cybersecurity challenges that the Federal Reserve is currently working to address?

The Federal Reserve Board (the Board) is keenly aware of the risks and threats within cyberspace. The Board follows the National Institute of Standards and Technology (NIST) Risk Management Framework as required by the Federal Information Security Modernization Act to manage its information security including cyber risks. Current areas of focus include ensuring sensitive information, such as personally identifiable information (PII), is being protected and handled appropriately, and protecting against advanced hacking techniques from nation states and other advanced actors, insider threats, and Distributed Denial of Service (DDOS) attacks. To address these challenges, the Board has implemented and continues to enhance our Data Loss Protection (DLP) program. The Board is also enhancing information handling policies; implementing data encryption at rest technologies, including for databases containing PII; enhancing incident response processes; and continually improving Advanced Persistent Threat and DDOS protection and detection capabilities. In addition, the Board is in the process of implementing the Department of Homeland Security's Einstein suite of advanced intrusion detection capabilities.

The Board and the Reserve Banks, which also follow an information security program based on NIST standards adapted to their environment, use a comprehensive defense in-depth approach whereby multiple layers of security controls are implemented to protect sensitive information as well as vigilantly monitoring probes and attacks on an ongoing basis. It is important to acknowledge, however, that no defense is foolproof. Early detection of attacks is just as important as prevention through multiple layers of defense. Hence, we continually work to identify and remediate attacks before any damage occurs.

The Federal Reserve also recognizes the systemic risk posed by cyber threats to the financial system. The global financial services sector has a heightened level of exposure to cyber risk due to the high degree of information technology intensive activities and the increasing interconnection between firms in the sector. As such, cyber risk mitigation and cyber resiliency initiatives continue to be high priorities for the Federal Reserve. To strengthen risk management practices across the sector and reduce the impact of a cyber-related incident, the Federal Reserve works independently and in collaboration with other agencies, public/private partnerships, and international authorities, to introduce and participate in programs to share information and benchmark from best-practices that combat the increasingly frequent and sophisticated emerging cybersecurity threats.

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[1] Jason Lange & Dustin Volz, Fed Records Show Dozens of Cybersecurity Breaches, Reuters, Jun. 1, 2016, available at http://www.reuters.com/article/us-usa-fed-cyber-idUSKCN0YN4AM.

b. What steps is the Federal Reserve taking to strengthen its protection of PII and other sensitive information?

We are continually improving our information handling policies and processes. Protecting sensitive information throughout its lifecycle from creation to destruction is a vital component of our overall cybersecurity strategy. In addition to working aggressively to minimize access to sensitive information based on "least privilege necessary" and "need to know" criteria, we have implemented and are enforcing email classification and labelling, as well as require document labeling. Additionally, we continue to enhance our DLP program while also implementing encryption of databases containing PII as well as other sensitive/mission critical data consistent with the requirements of the Federal Cybersecurity Enhancement Act.

c. What steps is the Federal Reserve taking to protect against insider threats?

Information handling processes and data loss protection capabilities are fundamental building blocks in strengthening our ability to identify and respond to insider threats. We continue to expand the use of automated solutions to assist us in ensuring that only authorized individuals have access to information and to prevent the movement of information to unauthorized locations including limiting the use of mobile data storage devices. We are also increasingly utilizing operational analytics to identify and respond to threats.

Our insider threat protection strategy is consistent with our layered protections strategy and focuses on people, processes, and technology. Our ongoing training and awareness program reinforces the importance to our employees of the need to safeguard sensitive information entrusted to them and the importance of using systems and data for authorized purposes only. Security processes associated with insider threats are focused on limiting access to sensitive information based on the tenets of "least privilege necessary" and "need to know" criteria. We strive to continually improve our investments in security technologies to enable us to detect early signs of anomalous activities indicative of insider or other forms of cyber threats.

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Representative Luetkemeyer:

1. As you know, Congress in statute and the Fed through regulation appropriately carved the business of insurance out of the Volcker Rule's restrictions. However, in the final rule, insurance companies which are also savings and loan holding companies because of a subsidiary thrift must meet unnecessarily burdensome compliance requirements that are based on total consolidated assets of the insurance company, rather than being limited to the size of financial subsidiaries that are subject to the Volcker Rule's prohibitions. This does not comport with congressional intent and the spirit of the Volcker Rule, which was not targeting, and specifically exempted, insurance company activity. Do you agree that insurance assets should be excluded from consolidated assets for purposes of Volcker compliance, since the business of insurance was carved out of the rule?

Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the statutory provision known as the "Volcker Rule"), which added a new section 13 to the Bank Holding Company Act of 1956 (BHC Act), generally prohibits any banking entity from engaging in proprietary trading, and from acquiring or retaining an ownership interest in, sponsoring, or having certain relationships with a covered fund, subject to certain exemptions. Under the terms of the statute, the Volcker Rule applies to any company that controls an insured depository institution, and any affiliate or subsidiary of any such entity. As a result, the Volcker Rule and the implementing rules issued by the Federal Reserve, the Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Securities and Exchange Commission, and Commodity Futures Trading Commission (the "Agencies") apply to savings and loan holding companies and their affiliates and subsidiaries.

Section 13 of the BHC Act requires the Agencies to implement rules "to insure compliance with this section." The Federal Reserve Board's (Board) rules provide that each banking entity must establish a compliance program, with enhanced minimum standards applicable to institutions that meet certain additional criteria set forth in the rules. These enhanced minimum standards apply to banking entities with the most significant covered trading activities or those that meet a specified threshold of total consolidated assets. However, the Board's rules expressly provide that with regard to the compliance program established by a banking entity, the "terms, scope and detail of the compliance program shall be appropriate for the types, size, scope, and complexity of activities and business structure of the banking entity" (12 CFR 248.20(a)). Therefore, each institution subject to the enhanced minimum compliance program requirements, including a large savings and loan holding company with significant insurance-related assets, has flexibility under the rule to tailor its compliance program based on the nature of its activities.

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Representative Moore:

1. I have been an advocate of the Orderly Liquidation Facility (OLF) for its ability to streamline liquidation of G-SIFIs in certain circumstances.

Do you believe that Wall Street requires a government determination to figure out if a firm is systemically significant?

The core reforms put in place by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), and related reforms by the U.S. financial regulatory agencies, have created a safer and stronger financial system. The Financial Stability Oversight Council's (FSOC) designation authority is an important tool for the protection of financial stability. As evident in the financial crisis, significant sources of systemic risk were able to build in financial firms that were not supervised or regulated on a consolidated basis, but whose failure or distress could—and did—cause extensive damage to our country's financial system and economy. Primary financial regulatory agencies may not have the authority to apply new or heighted safeguards for specific financial activities or practices conducted by nonbank financial firms under their jurisdictions to address risks posed to financial stability. The FSOC's designation authority helps to fill these gaps. It allows consolidated supervision and regulation of financial firms whose activities or distress could pose a threat to our country's financial stability, with tools to address financial stability risks.

Do you believe that repealing the OLF would create uncertainty and contagion in the event of another crisis?

As stated in my previous answer, the core reforms put in place by the Dodd-Frank Act, including the Orderly Liquidation Authority under Title II, have created a safer and stronger financial system.

A key lesson we learned from the financial crisis was that we needed a better way to resolve a large financial firm. Government authorities were faced with the choice between a government bailout of a large financial firm and a chaotic and disorderly collapse of a large financial firm that threatened financial stability. Title II of the Dodd-Frank Act provides the government with a workable framework for the orderly resolution of a large financial firm – thus reducing the need for government bailouts in any future financial crisis.

Bankruptcy should be the preferred route for a failing firm. We have made great strides through the living will process to make our largest banking firms easier to resolve under the traditional bankruptcy code, but given the uncertainties around how financial crises unfold, it is prudent to keep Title II as a backstop resolution framework.

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Representative Moore:

2. Dodd-Frank created greater transparency and stability by directed more trades through market utilities, including for derivative trades. Title VIII (8) established a framework to assessing systemic risk associated with these utilities and granted the Fed, CFTC, and SEC enhanced regulatory authority over these utilities.

a. Do you agree that if Title VIII of Dodd-Frank were removed, as is contemplated in the CHOICE Act, the potential for systemically significant market events might increase due to the resulting absence of enhanced supervision of CCPs, as well as the absence of emergency liquidity facilities and risk-free accounts for customer margin?

Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) creates an enhanced framework for the supervision of financial market utilities (FMUs), including central counterparties that have been designated as systemically important by the Financial Stability Oversight Council. This enhanced supervision framework allows the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), and the Board of Governors of the Federal Reserve System (Board) to prescribe enhanced risk management standards for FMUs and provides mechanisms for information-sharing and coordination among the supervisory agencies. Title VIII provides the Board with the ability to obtain a certain level of insight across all designated FMUs through examination participation and notification of material rule changes and also provides the Board with certain limited enforcement authority.

Effective risk management of FMUs enhances the stability of the financial system, more broadly. It is important that FMUs be overseen consistently, and in a manner that focuses on the safety of the system as a whole and not just its individual components. The role given to the Board under Title VIII allows for such a systemic view of FMUs and assists the supervisory agencies in promoting consistency across the various designated FMUs.

The SEC, CFTC, and Board have each adopted regulations that have materially raised the expectations to which systemically important FMUs are held and that have improved FMUs' credit and liquidity risk management frameworks and enhanced their operational resilience. Further, the CFTC, SEC, and Board's respective requirements for FMUs designated under Title VIII require these firms to manage their risks by relying on private-sector resources only, without any assumption of reliance on public funds during times of market stress.

Title VIII permits the Board to authorize a Federal Reserve Bank to establish an account for and provide services to a designated FMU. Conducting money settlements using central bank money, where available, is consistent with strong risk management practices. It is likely that that the provision of accounts and services to certain designated FMUs has reduced risk in the system by minimizing credit and liquidity risk associated with holding margin payments and contingent liquidity resources in commercial bank accounts.

Title VIII also permits the Board to authorize a Federal Reserve Bank to provide discount and borrowing privileges to a designated FMU only in unusual or exigent circumstances, upon an affirmative vote of a majority of the Board of Governors then serving, after consultation with the Secretary of the Treasury, and upon a showing by the FMU that it is unable to secure adequate credit accommodations from other banks.

The variety of tools created by Title VIII have provided effective mechanisms for highlighting the importance of risk management to FMUs and for the agencies to oversee and coordinate the implementation of FMU risk-management policies and procedures. Collectively, these activities have resulted in a reduced likelihood of market stress, which may have systemic implications, and have enhanced the ability of FMUs and supervisory agencies to respond to those stresses should they occur. These results are consistent with the principle of reducing reliance on public funds in response to market stress or a financial crisis.

b. How might American consumers and workers be impacted by the return of greater systemic risk?

Over the past three decades, the financial system has evolved to rely more and more on FMUs that connect banks, broker-dealers, financial advisors, and other financial institutions, as well as in many cases farmers and businesses of all sizes as they try to reduce the risks associated with their core business activities. FMUs generally reduce the credit risk faced by the parties that rely on these entities as connection points to facilitate the exchange of cash and securities of all kinds, and also can materially reduce the amount of liquidity needed to complete such transactions.

As discussed above, Title VIII of the Dodd-Frank Act has strengthened the supervisory framework over FMUs as well as raised the expectations for the risk management standards for designated FMUs. If Title VIII were repealed and this structure removed, the likelihood for disruptions that might impact a wide set of financial institutions, small businesses, and farmers who rely on FMUs on a daily basis may increase. As seen after the financial crisis of 2008, such market stress and disruptions can propagate across the financial system and have real consequences for the economy, including households and businesses.

Questions for The Honorable Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System from Representative Sherman:

1. The latest round of Basel capital rules established punitive risk weightings for mortgage servicing rights (MSR), which may have caused banks to rethink whether to own these assets. Ultimately, these punitive standards may impact American borrowers through higher rates or reduced access to mortgage credit.

What are your thoughts about strict conformity with the international Basel framework, and do you think it is appropriate to ensure that the U.S. rules are implemented or amended in a fashion that addresses possible harm to consumers and businesses, specifically on the MSR issue, and more generally where the framework puts U.S. banks and their lending activity at a competitive disadvantage?

The Board of Governors of the Federal Reserve System (Board), Office of the Comptroller of the Currency, and Federal Deposit Insurance Corporation (federal banking agencies) have long limited the inclusion of mortgage servicing assets (MSAs) in regulatory capital in light of the high level of uncertainty regarding the ability of banking organizations to realize value from these assets, especially under adverse financial conditions. These regulatory capital limitations help protect banks from sudden fluctuations in the value of MSAs and from the inability to quickly divest these assets at their full estimated value during periods of financial stress. In the July 2016 *Report to the Congress on the Effect of Capital Rules on Mortgage Servicing Assets*, the federal banking agencies together with the National Credit Union Administration noted that MSA valuations are inherently subjective and uncertain because the valuations rely on assessments of future economic variables.

As a member of the Basel Committee on Banking Supervision (BCBS), the Board works with other BCBS members to develop minimum international regulatory capital standards that promote consistency across the largest banking organizations in BCBS member jurisdictions and avoid a race-to-the-bottom in international prudential regulation. Before adopting any changes to its regulations, the Board invites public comment and considers any unique features of the U.S. economy and financial sector. After inviting public comment on a revised capital treatment of MSAs that was based on work conducted by the Board and other members of the BCBS, in 2013 the Board and the Office of the Comptroller of the Currency adopted a final rule that modified the capital treatment of MSAs to better address the risks associated with these assets.

The Board recognizes community banks' concerns with respect to the burden and complexity of the U.S. regulatory capital framework. The Board, along with the other federal banking agencies, recently committed to address such concerns in their report on the review of the Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA report), which emphasized the "goal of reducing regulatory burden on community banks while at the same time maintaining safety and soundness and the quality and quantity of regulatory capital in the banking system." As described in the EGRPRA report, the federal banking agencies are jointly developing a proposal to simplify certain aspects of the regulatory capital framework, including the treatment of MSAs.

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